Please quote reference: IG3162

ALLOWANCES AND PAYMENTS TO EMPLOYEES – EXEMPTION UNDER SECTION CW 13 OF THE INCOME TAX ACT 2004

This Interpretation Guideline sets out the Commissioner of Inland Revenue's view on the interpretation of section CW 13 of the Income Tax Act 2004. It sets out the general principles in applying section CW 13 in respect of a number of allowances or payments made to employees that could be seen to be of a private or domestic nature, or capital nature.

In October 2006 the Commissioner issued a draft "Question we've been asked" item (QB00056) dealing with the treatment of amounts paid by an employer, in connection with the relocation of new employees. Submissions received in response to QB00056 have been taken into account in the development of this Interpretation Guideline.

If this Interpretation Guideline is finalised in its current form, it will supersede any prior statement made by the Commissioner in relation to the type of allowances or payments discussed in the Guideline, including an item titled "*Relocation Expenses — Section 73 of the Income Tax Act 1976*" in Public Information Bulletin No. 171 (March 1988). It is also anticipated that QB00056 will not be finalised as this wider statement covers the exemption of allowances and payments made to the relocation of new employees. The application date, and any transitional issues will also be considered before this Interpretation Guideline is finalised.

Summary

1. Unless otherwise stated, all legislative references are to the Income Tax Act 2004.

2. Generally allowances paid to employees in connection with employment or service are income of the employee. However, the allowance may represent a payment from the employer relating to expenditure incurred by the employee. These type of allowances and/or payments are income of the employee unless excluded because they are exempt, or the payment is reimbursing the employee for expenditure that is actually the employer's liability.

3. For an amount paid to be exempt income, the expenditure for which the payment is made must be such that it would be an allowable deduction to the employee, if the employment limitation did not exist.

4. Where an employee is reimbursed by their employer for expenditure paid in connection with their employment or service where that expenditure is actually the liability of their employer, that amount reimbursed is not income. However the employer may still need to consider whether there has been a benefit provided to the employee (to which the liability related) which is subject to fringe benefit tax.

5. This Interpretation Guideline provides general guidance on how the Commissioner interprets and applies the provisions that exclude or exempt these types of payments being income of the employee. This Interpretation Guideline focuses on the treatment of the payment in the hands of the employee and does not consider issues of deductibility and fringe benefit tax for the employer.

6. Section CW 13 sets out when a payment to an employee will be exempt from income tax when the expenditure for which the allowance or payment is made could be seen to be of a private or domestic nature, or capital nature.

7. The Commissioner has considered three Court of Appeal cases dealing with the deductibility of employment-related expenditure under the former section 105 and the Fourth Schedule of the Income Tax Act 1976 (1976 Act). While these cases were decided under legislation that has now been repealed, they deal with the issue of what is expenditure of a private or domestic nature and are, therefore, still helpful in determining whether or not such expenditure will be deductible under the current legislation and exempt from tax under section CW 13, which is the focus of this Interpretation Guideline. From these cases the Commissioner has developed a set of questions that will assist in determining whether an expenditure, of the type under consideration, will qualify for exemption under section CW 13. The application of these questions is illustrated in relation to some of the more commonly paid allowances that could be seen to be of a private or domestic nature such as meal and clothing allowances and reimbursing payments made in respect of employee relocation expenses. This Interpretation Guideline also considers the treatment under section CW 13 of a payment or allowance to an employee which represents a payment or reimbursement for capital expenditure.

8. The Commissioner considers that for an allowance or a payment (not being an allowance or a payment made to the employee in respect of capital expenditure incurred by the employee) to be exempt from income tax under section CW 13, all the following three questions must be answered in the affirmative:

   (i) Was the employee performing an obligation under the contract of service at the time the expenditure was incurred?

   (ii) Did the obligation serve the purpose of the income-earning process of deriving income from employment?

   (iii) Was the expenditure incurred by the employee necessary as a practical requirement of the performance of the obligation?

9. These questions were not expressly formulated by the courts in relation to the legislation under which the Court of Appeal cases were decided. However, the cases are the most relevant in the area of the tax deductibility of employment-related expenditure. From these cases, the Commissioner has formed the above set of questions he considers most applicable to the current

legislation. If the three questions are answered in the affirmative, it is the Commissioner's view that the exemptions in section CW 13 would apply. [However, this would be subject to the other limitations in section DA 2 not applying and in particular the capital limitation in section DA 2(1).]

10. This Interpretation Guideline concludes that some allowances or payments made to employees that could be seen to be of a private or domestic nature, or capital nature, and may have been treated as exempt from income tax in the past will no longer qualify for exemption under the current legislation.

11. In considering the issues in this Interpretation Guideline, the Commissioner has applied the current legislation to three of the more common types of allowances or reimbursements paid to employees (that could be seen to be of a private or domestic nature, or capital nature), namely payments in respect of meals, clothing and home relocation. The Commissioner has determined that the exemption of those payments will be limited to the following:

Meal allowances or reimbursements

12. The Commissioner considers that the following payments by an employer to an employee for the reimbursement of meal costs (whether actual reimbursement or an allowance paid to cover such costs), where the employee pays the cost of the meal, will only qualify for exemption under section CW 13 where:

- meals are taken as part of business or work meetings; or
- meals are taken as part of entertaining business clients; or
- meals are taken by the employee when absent from his or her home for attending a business conference or meeting where such absence necessitates the employee being absent from home overnight.

Clothing allowances or reimbursements

13. The Commissioner considers the following allowances or reimbursement of clothing costs, where the employee pays for the costs of the clothing, will only qualify for exemption under section CW 13 where:

- the expenditure is in respect of protective clothing or footwear; or
- the expenditure is in respect of a uniform or special clothing in the nature of a uniform; or
- the employee incurs abnormal expenditure on conventional clothing due to excessive wear and tear or the need for a greater quantity of conventional clothing.

Home relocation allowances or reimbursements

14. The Commissioner considers that employer paid allowances or reimbursements of relocation costs will qualify for exemption under section CW 13 when the relocation costs relate to a requirement in the employment contract that the employee transfers *at the request* of the employer *at any time* and the employee is relocated *in the same job* and moves home to the new location. It is also relevant to note that some costs associated with employee relocation may not be exempt because they are of a capital nature.

15. Attached in an appendix to this Interpretation Guideline are three flow charts that will provide guidance in determining whether a payment made by an employer to an employee is:

- exempt from income tax under section CW 13;
- subject to income tax;
- within the fringe benefit tax provisions;
- not treated as income of the employee.

Background

16. Section CE 1 lists items that are income derived by a person in connection with their employment or service. Amounts paid as **allowances** and amounts paid as **expenditure on account of an employee** are listed in section CE 1. However these amounts can qualify for exemption under section CW 13 or be excluded from income under section CE 5(3)(c).

17. For an amount paid to be exempt income under section CW 13, the amount must be in respect of expenditure that would be an allowable deduction to the employee, if the employment limitation in section DA 2(4) did not exist. This section prohibits deductions for expenditure or loss incurred in gaining or producing income from employment (the "employment limitation"). Certain deductions are not allowed when calculating assessable income. The relevant ones in relation to allowances and payments made to employees are deductions for private and domestic expenditure (the "private limitation") and capital expenditure (the "capital limitation").

18. For an amount to be excluded under section CE 5(3)(c), the reimbursement by the employer must be for expenditure paid by the employee in connection with their employment or service where that expenditure is actually the liability of the employer. The employer will still need to consider whether there has been a benefit provided to the employee which is subject to fringe benefit tax.

Legislation

19. Sections BD 2, CE 1, CE 5(1)–(3)(c), CW 13, CW 14, and DA 2(1)–(4) and (7) are as follows:

BD 2 Deductions
An amount is a deduction of a person if they are allowed a deduction for the amount under Part D (Deductions)

CE 1 Amounts derived in connection with employment
The following amounts derived by a person in connection with their employment or service are income of the person:

(a) salary or wages or an allowance, bonus, extra pay, or gratuity:

(b) expenditure on account of an employee that is expenditure on account of the person:

(c) the market value of board that the person receives in connection with their employment or service:

(d) a benefit received under a share purchase agreement:

(e) directors' fees:

(f) compensation for loss of employment or service:

(g) any other benefit in money.

CE 5 Meaning of expenditure on account of an employee

Meaning

(1) Expenditure on account of an employee means a payment made by an employer relating to expenditure incurred by an employee.

Inclusion

(2) Expenditure on account of an employee includes a premium that an employer pays on a life insurance policy taken out for the benefit of the employee (or their spouse or civil union partner or their child). This subsection is overridden by subsection (3)(f) to (i).

Exclusions

(3) Expenditure on account of an employee does not include—

(a) expenditure for the benefit of an employee, or a payment made to reimburse an employee, under section CW 13 (Expenditure on account, and reimbursement, of employees):

(b) an allowance for additional transport costs under section CW 14 (Allowance for additional transport costs):

(c) expenses that an employee pays in connection with their employment or service to the extent to which the expenditure is their employer's liability, if the employee undertakes to discharge the liability in consideration of the making of the payment by the employer:

…

CW 13 Expenditure on account, and reimbursement, of employees

Exempt income: expenditure on account

(1) Expenditure on account of an employee incurred by an employer in connection with the employee's employment or service is exempt income of the employee to the extent to which the expenditure is expenditure for which the employee would be allowed a deduction if they incurred the expenditure and if the employment limitation did not exist.

Exempt income: reimbursement

(2) An amount that an employer pays to an employee in connection with the employee's employment or service is exempt income of the employee to the extent to which it reimburses the employee for expenditure for which the employee would be allowed a deduction if the employment limitation did not exist.

Estimated expenditure of employees

(3) For the purposes of subsection (2),—

(a) the employer may make, for a relevant period, a reasonable estimate of the amount of expenditure likely to be incurred by the employee or a group of employees for which reimbursement is payable; and

(b) the amount estimated is treated as if it were the amount incurred during the period to which the estimate relates.

CW 14 Allowance for additional transport costs

Exempt income

(1) An allowance that an employee receives from an employer to reimburse the employee's additional transport costs is exempt income to the extent to which the employee incurs the costs in connection with their employment and for the employer's benefit or convenience.

Estimated expenditure of employees

(2) For the purposes of subsection (1),—

(a) the employer may make, for a relevant period, a reasonable estimate of the amount of expenditure likely to be incurred by the employee or a group of employees for which reimbursement is payable; and

(b) the amount estimated is treated as if it were the amount incurred during the period to which the estimate relates.

Meaning of additional transport costs

(3) In this section, additional transport costs means the costs to an employee of travelling between their home and place of work that are more than would ordinarily be expected. The costs must be attributable to 1 or more of the following factors:

(a) the day or time of day when the work duties are performed:

(b) the need to transport any goods or material for use or disposal in the course of the employee's work:

(c) the requirement to fulfil a statutory obligation:

(d) a temporary change in the employee's place of work while in the same employment:

(e) any other condition of the employee's work:

(f) the absence of an adequate public passenger transport service that operates fixed routes and a regular timetable for the employee's place of work.

Quantifying additional transport costs

(4) Additional transport costs are quantified as follows:

(a) when the additional transport costs are attributed to a factor described in any of subsection (3)(a) to (e), the amount by which the costs are more than the employee's ordinarily expected travel costs without reference to that factor:

(b) when the additional transport costs are attributed to the factor described in subsection (3)(f), the amount by which the costs are more than $5 for each day on which the employee attends work:

(c) except in special circumstances, the costs of travelling any distance over 70 kilometres in 1 day are not taken into account in calculating additional transport costs.

DA 2 General limitations

Capital limitation

(1) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is of a capital nature. This rule is called the capital limitation.

Private limitation

(2) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is of a private or domestic nature. This rule is called the private limitation.

Exempt income limitation

(3) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is incurred in deriving exempt income. This rule is called the exempt income limitation.

Employment limitation

(4) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is incurred in deriving income from employment. This rule is called the employment limitation.

Relationship of general limitations to general permission

(5) Each of the general limitations in this section overrides the general permission.

20. The following definitions in section OB 1 are relevant to the discussion on sections CW 13 and CW 14:

amount—

(a) includes an amount in money's worth:

(b) …

deduction, for a person, means a deduction of the person under section BD 2 (Deductions)

employee—

(a) means a person who receives or is entitled to receive a source deduction payment:

(b) in sections CW 13 (Expenditure on account, and reimbursement, of employees) and CW 14 (Allowance for additional transport costs),—

(i) means a person who receives or is entitled to receive a source deduction payment; and

(ii) includes a person to whom section OB 2(2) (Meaning of source deduction payment: shareholder-employees of close companies) applies:

…

employer—

(a) means a person who pays or is liable to pay a source deduction payment:

(b) …

employment limitation is defined in section DA 2(4) (General limitations)

expenditure on account of an employee is defined in section CE 5 (Meaning of expenditure on account of an employee)

source deduction payment is defined in section OB 2(1) (Meaning of source deduction payment: shareholder-employees of close companies)

21. Section OB 2(1) states:

OB 2 Meaning of source deduction payment: shareholder-employees of close companies

(1) In this Act, except as provided in subsection (2), source deduction payment means a payment by way of salary or wages, an extra pay, or a withholding payment, but does not include an amount attributed in accordance with section GC 14D.

Application of the Legislation

22. Section CW 13 operates to exempt allowances and payments that are expenditure on account of an employee that would otherwise be income derived in connection with the employee's employment or service under section CE 1.

23. "Employee" is defined in section OB 1 to mean for the purposes of section CW 13 a person who receives or is entitled to receive a source deduction payment. "Employer" is also defined in section OB 1 to mean a person who pays or is liable to pay a source deduction payment. "Source deduction payment" is defined in section OB 2(1) to mean a payment by way of salary or wages, an extra pay, or a withholding payment. A person receiving a withholding payment is an employee for the purposes of section CW 13. This means a person in receipt of a withholding payment could qualify for an exemption for an allowance paid in addition to the withholding payment.

24. The reference to "employee" in this Interpretation Guideline also includes (where appropriate) a person in receipt of withholding payments.

The meaning of "in connection with" in section CE 1

25. The phrase "in connection with" in section CE 1 replaced the phrase "in respect of or in relation to" used in the corresponding provision, the definition of "monetary remuneration", in the Income Tax Act 1994 (1994 Act). Section YA 3(3) provides that provisions in the 2004 Act are intended to have the same effect as the corresponding provisions in the 1994 Act, although they have been rewritten. The exception is, pursuant to section YA 3(5), where an "identified policy change", as specified in schedule 22A, exists.

26. In this instance no identified policy change has been specified in schedule 22A. Therefore, the presumption is that the adoption of the term "in connection with" was not intended to give rise to an interpretation that differs from that which would apply if the term "in respect of or in relation to", as used in the definition of "monetary remuneration" under the 1994 Act, still applied. It is therefore relevant to consider the meaning of the phrase "in respect of or in relation to" in the interpretation of the phrase "in connection with" in this situation.

27. The *Concise Oxford Dictionary* (Oxford University Press, 11th ed. Revised 2006) defines "connection" as a link or relationship between people or things.

28. The courts have considered the meaning of "in respect of or in relation to" on several occasions (*State Government Insurance v Rees* (1979) 144 CLR 549, *Nowegijick v R* (1983) 144 DLR (3d) 193, *Smith v FCT* 19 ATR 27, *FCT v Rowe* (1995) 95 ATC 4,691, *Shell New Zealand Ltd v CIR* (1994) 16 NZTC 11,303 and *CIR v Fraser* (1996) 18 NZTC 12,607). In summary, these cases explain the meaning of the phrase as follows:

- The words "in respect of or in relation to" have a very wide meaning.
- There must be a sufficient connection between the subjects according to the context in which the words are used. There must be a sufficient or material relationship between the benefit and the employment.

Therefore, the phrase "in connection with" has the same wide meaning as the former phrase "in respect of or in relation to".

29. It is acknowledged that not all payments by an employer to an employee will be considered as being amounts derived in connection with employment or service: see e.g. Public Ruling BR Pub 06/06: *Employment Court Awards for Lost Wages or Other Remuneration - Employers' Liability to Make Tax Deductions*. However, when an employer makes a payment to an employee, it will generally be taken to be "in connection with" the employee's employment or service, unless the parties can establish that the particular facts are otherwise.

30. In considering whether such a connection exists in the context of the definition of the former phrase "monetary remuneration", the courts have focused on whether the payment is a consequence of the employment or service (*Smith v FCT*, *FCT v Rowe*, *CIR v Fraser*, and *Shell New Zealand Ltd v CIR*).

31. Taxation Review Authority (TRA) decisions on the former legislation also illustrate the wide meaning that may be attributed to the words "in respect of or in relation to the employment or service of the taxpayer". In *Case L92* (1989) 11 NZTC 1,530, Barber DJ considered the term "monetary remuneration" in relation to a payment of compensation for unjustified dismissal under the Industrial Relations Act 1973. The compensation was calculated on the basis of the personal hurt and procedural unfairness suffered by the objector. Barber DJ found that, even though the payment was compensatory in nature, it was money received in respect of the objector's employment. He stated that the words "compensation for loss of office or employment", "emolument (of whatever kind), or other benefit in money" and "in respect of or in relation to the employment or service of the taxpayer" have a wide embrace and go beyond the narrower concept of "salary, wage, allowance, bonus gratuity, extra salary" which precede them. On the particular facts of this case he held that "monetary remuneration", interpreted widely, covered the payment in issue.

32. Some examples of a court holding the payment to be a consequence of the employment relationship are as follows:

- An employee incurred costs when complying with the employer's request to transfer (*Shell New Zealand Ltd v CIR*).

- An employee received a lump sum payment from a new employer to compensate the employee for a possible loss of a capital gain on share options in the employee's former employer company (*Pickford v FC of T* 98 ATC 2,268). The Administrative Appeals Tribunal found that the $20,000 payment was an inducement to enter into the employment of the new employer and its source was in the service to be rendered by the taxpayer. The payment was an incident of the taxpayer's income-earning activities as an employee.

- An employee received payments for successfully completing a course of study that was related to the employee's employment (*Smith v FCT*).

- A soccer player received a payment from the player's current club to transfer to another club. The transfer fee was deemed to be "an emolument from employment" (*Shilton v Wilmshurst (Inspector of Taxes)* [1991] 3 All ER 148 (HL)).

33. Two examples of a court holding that a payment to an employee had *not* arisen as a consequence of an employment relationship are as follows:

- A payment made in respect of a debt owed to the employee for paying accounts that were the employer's liability. In such circumstances, the true relationship between the employer and employee in respect of the payment is not that of employer–employee, but of creditor–debtor (*TRA Case M23* (1990) 12 NZTC 2,124).

- A payment to compensate for the giving up of a vocation as a television current affairs presenter (*CIR v Fraser*).

34. It is the Commissioner's view, supported by relevant case law, that for the purposes of section CE 1 a payment made "in connection with … employment or service" has a very wide meaning and would include payments made in respect of future, present, or past employment or service provided there is a link between the payment and the recipient that arises from the employment or service relationship. The nature of the payment is critical in order to determine whether it is salary or wages, an allowance, a bonus, extra salary, or other benefit in money, or a payment on account of an employee (as described immediately below), thereby being amounts derived in connection with the employment or service of the person.

Expenditure on account of an employee

35. Section CE 1 sets out certain items that will be the income of employees in relation to their employment or service. One item (under paragraph (b)) is "expenditure on account of an employee", which is defined in section CE 5.

36. Section CE 5(1) and (3)(a)–(c) states:

> (1) **Expenditure on account of an employee** means a payment made by an employer relating to expenditure incurred by an employee.
>
> …
>
> (3) **Expenditure on account of an employee** does not include—
>
> (a) expenditure for the benefit of the employee, or a payment made to reimburse an employee, under section CW 13 (Expenditure on account, and reimbursement, of employees):
>
> (b) an allowance for additional transport costs under section CW 14 (Allowance for additional transport costs):
>
> (c) expenses that an employee pays in connection with their employment or service to the extent to which the expenditure is their employer's liability, if the employee undertakes to discharge the liability in consideration of the making of the payment by the employee:

37. In order to be income under CE 1, section CE 5(1) requires a payment by the employer relating to expenditure incurred by an employee. Certain payments are excluded from the definition of "expenditure on account of an employee" under subsection (3) of section CE 5. These include:

- expenditure that qualifies for exemption under section CW 13:

- payment of an allowance for additional transport costs under section CW 14:

- a payment that is reimbursing the employee for expenditure that is actually the employer's liability under section CE 5(3)(c).

The focus of this Interpretation Guideline is the exemption provided in section CW 13. The exclusions provided in sections CE 5(3)(b) and CE 5(3)(c) are discussed further below.

Amounts exempt under section CW 13

38. Section CW 13 exempts from income tax the following types of payments to (or on behalf of) employees:

39. Payments that are expenditure on account of an employee and for which the employee would be entitled to a deduction (from income from employment) if the employment limitation did not exist (subsection (1)).

40. Payments that reimburse the employee to the extent they reimburse the employee for expenditure for which the employee would be allowed a deduction (from income from employment) if the employment limitation did not exist (subsection (2)).

41. Section CW 13, therefore, provides for the exemption of payments made to employees when the expenditure that the payment is made in respect of, would be a deductible expense (from that income from employment) if the employment limitation did not exist. In effect section CW 13 provides that employees are entitled to an exemption for expenditure on the same basis that deductibility of expenditure applies to all taxpayers. As with all classes of taxpayer, expenditure of a private or domestic or capital nature is not tax deductible. This means any payment or reimbursement to an employee that is of a private or domestic or capital nature cannot be exempt from income tax in the hands of the employee.

42. This Interpretation Guideline looks at these types of payments and reimbursement in the context of the exemption of payments to employees that could be seen to be of a private or domestic or capital nature. This statement focuses, initially, on reimbursement payments that come within section CW 13(2).

43. Section CW13 (1) has similar tests to section CW 13 (2) but additional issues must be considered which are discussed in more detail later in this Interpretation Guideline.

Reimbursing payments: section CW 13(2)

44. For a payment to qualify as an exemption under section CW 13(2), it must satisfy all of the following three tests:

(i) The payment must be made to the employee in connection with the employee's employment or service.

(ii) The payment must reimburse the employee.

(iii) The reimbursement must be for expenditure for which the employee would have been able to claim a deduction were it not for the employment limitation.

Test 1: The payment must be made to an employee in connection with the employee's employment or service

45. The first test involves the consideration of two factors:

- Is the recipient an employee?
- Is the payment made in connection with the employee's employment or service?

Is the recipient an employee?

46. The recipient of the payment must be an employee. The definition of employee has been discussed earlier in this Interpretation Guideline. An employee is a person who receives or is entitled to receive a source deduction payment.

47. Any person who is not an "employee" is outside the scope of section CW 13, so any payment the person receives that may otherwise be income cannot be exempted from tax under the section.

Is the payment made in connection with the employee's employment or service?

48. The payment must also be in connection with the employee's employment or service. This means a necessary relationship must exist between the payment the employee receives and the employee's employment or service. As discussed above, a payment in connection with employment or service has a very wide meaning and can include payments received before, during, and after the employee has actually commenced or finished the employment or service relationship with a particular employer. Where there is a relevant employment or service relationship, the Commissioner considers that the payment will have the necessary connection with the employee's employment or service unless it can be established otherwise.

Test 2: The payment must reimburse the employee

49. Section CW 13(2) applies to exempt an amount paid only to the extent the payment reimburses (or is an allowance that reimburses) the employee.

50. A payment will constitute a reimbursement of the employee's expenditure when it reimburses expenditure paid by the employee (*Roads and Traffic Authority of NSW v FCT* 93 ATC 4,508, *TRA Case E37* (1981) 5 NZTC 59,241, and *TRA Case E82* (1981) 5 NZTC 59,434).

See also *TRA Case K15* (1988) 10 NZTC 196 where Bathgate DJ (at page 204) stated:

> For a payment to constitute a reimbursement I think there would have to be first proved a disbursement, an expenditure paid, before that could be reimbursed.

The employee must have incurred (or be likely to incur) some expenditure in order that a reimbursement by the employer can attract the exemption provided by the section.

51. It is not necessary that the reimbursement is the actual amount the employee has expended. Section CW 13(3) covers the employer's estimation of an amount of expenditure an employee is likely to incur for which a "reimbursement allowance is payable". Section CW 13(3) states:

> (3) For the purposes of subsection (2),—
>
> (a) the employer may make, for a relevant period, a reasonable estimate of the amount of expenditure likely to be incurred by the employee or a group of employees for which reimbursement is payable, and
>
> (b) the amount estimated is treated as if it were the amount incurred during the period to which the estimate relates.

Therefore, in section CW 13(2) the word "amount" will include not only actual reimbursements made to employees but also "reimbursing allowances" made to cover estimated expenditure.

52. A travel allowance paid to a travelling sales representative who is an employee is an example of a reimbursing allowance that could meet the requirements for estimation under section CW 13(2).

53. Amounts paid or allowances given to compensate the employee for the nature of the employee's work that do not require any outlay by the employee (so there is nothing for the employer to reimburse) will not qualify for exemption. Non-qualifying payments could include allowances such as dirt money or height money or other allowances paid to compensate the employee for working in unpleasant or demanding conditions, rather than to compensate the employee for any expenditure incurred.

54. Section CW 13(3) provides that an employer may estimate the amount of expenditure likely to be incurred by an employee or a group of employees for which a reimbursing allowance is payable. However, to "reimburse" an employee, as contemplated by the section, there must be specific actual or future expenditure to reimburse.

Test 3: The reimbursement must be for expenditure for which the employee would have been able to claim a deduction were it not for the employment limitation

55. Under section CW 13(2), for an amount to be exempt the payment must reimburse the employee for expenditure the employee would have been entitled to deduct if it were not prohibited by the employment limitation.

Statutory limitations

56. In the context of this Interpretation Guideline, statutory limitations affect the deductibility of expenditure incurred by taxpayers deriving income from employment. Subpart DA sets out the general rules relating to the deductibility of expenditure. Section DA 1 is the "general permission" section that permits a deduction for an amount of expenditure or loss to the extent it is incurred by the person in deriving their assessable income.

57. However, the employment limitation in section DA 2(4) denies a person a deduction for an amount of expenditure or loss to the extent it is incurred in deriving income from employment. This employment limitation is, however, ignored when deciding whether an amount (an allowance or a reimbursement) paid by an employer to an employee is exempt from tax under section CW 13.

58. Also relevant are sections DA 2(1) (capital limitation) and DA 2(2) (private limitation). These subsections prevent a taxpayer from claiming a deduction for expenditure of a capital nature or of a private or domestic nature. This requires an analysis of what constitutes expenditure of a "private or domestic" or "capital" nature.

Private or domestic expenditure

59. To be exempt under section CW 13(2), the expenditure the reimbursement from the employer is intended to cover must, if it were not for the employment limitation, be an allowable deduction to the employee. Therefore, deductibility needs to be considered in accordance with section DA 1, that is, the expenditure must "be incurred … in deriving … assessable income".

60. One of the additional tests for deductibility is that the expenditure must not fall within the exclusion of the private limitation; that is, it must not be expenditure of "a private or domestic nature". [The other relevant additional test for deductibility is that the expenditure must not fall within the exclusion of the capital limitation; that is, it must not be expenditure of "capital nature". This test is discussed later in this Interpretation Guideline.]

61. What constitutes private or domestic expenditure in an income tax context has been discussed by the courts in New Zealand and overseas on numerous occasions. Inevitably, the conclusions reached by the courts have been based on the particular facts of each case.

62. In New Zealand, the Court of Appeal has dealt with three cases that considered the deductibility of expenditure by employees where that expenditure was considered by the Commissioner to be of a private or domestic nature (*CIR v Haenga* (1985) 7 NZTC 5,198, *CIR v Belcher* (1988) 10 NZTC 5,164, and *Hunter v CIR* (1990) 12 NZTC 7,169). These cases were considered under sections 104, 105 and 106 and the Fourth Schedule of the 1976 Act (all now repealed).

63. The court considered that under the 1976 Act, section 105 (deductibility of expenditure from income from employment) was a substitution for the main deductibility provision of section 104. Section 104 had virtually the same wording as section BD 2(1) of the 1994 Act, which had the same effect as section DA 1(1) of the 2004 Act. Therefore, the principles in relation to whether expenditure is private or domestic from those decisions are likely to be appropriate when considering deductibility under the current legislation.

The cases

64. The taxpayers in the three Court of Appeal cases (*Haenga*, *Belcher*, and *Hunter*) were salary and wage earners (employees). When the cases were decided a specific regime in the 1976 Act dealt with the deductibility of expenditure for salary and wage earners. The legislative regime was as follows:

> **101 Deductions unless expressly provided**
>
> Except as expressly provided in this Act, no deduction shall be made in respect of any expenditure or loss of any kind for the purpose of calculating the assessable income of any taxpayer.
>
> **104 Expenditure or loss incurred in production of assessable income**
>
> In calculating the assessable income of any taxpayer any expenditure or loss to the extent which it—
>
> (a) Is incurred in gaining or producing the assessable income in any income year; or
>
> (b) Is necessarily incurred in carrying on a business for the purpose of gaining or producing the assessable income for any income year—
>
> may, except as otherwise provided in this Act, be deducted from the total income derived by the taxpayer in the income year in which the expenditure or loss is incurred.
>
> **105 Deduction for expenditure or loss incurred in production of income from employment**
>
> (1) …
>
> (2) For the purposes of section 104 of this Act, and notwithstanding the proviso to section 106(1)(d) of this Act, every taxpayer who in any income year derives assessable income that consists of income from employment shall be deemed to have incurred an amount of expenditure or loss in gaining or producing that income from employment equal to the greater of—
>
> (a) …

(b) An amount equal to the smaller of—

(i) The aggregate of the amounts of the expenditure and losses (being expenditure and losses incurred by the taxpayer in gaining or producing that assessable income) of any of the kinds specified in the Fourth Schedule to this Act, reduced by every amount received (whether before or after the incurring of that expenditure and those losses), by or on behalf of the taxpayer, in respect of or in relation to that expenditure and those losses: …

106 Certain deductions not permitted

(1) Notwithstanding anything in section 104 of this Act, in calculating the assessable income derived by any person from any source, no deduction shall, except as expressly provided in this Act, be made in respect of any of the following sums or matters:

(a) …

(j) Any expenditure or loss to the extent to which it is of a private or domestic nature; …

Fourth Schedule

Items of expenditure or loss deductible in respect of income from employment:

……

8. Expenditure incurred by the taxpayer for the purposes of, and as a condition of, his employment, and not being expenditure of any of the kinds referred to in any of the foregoing provisions of this Schedule.

65. In summary, the sections had the following effect:

- Section 104 was the general source of tax deductibility, but it was subject to the restrictions in section 106 (for the purposes of this discussion, the prohibition in section 106(1)(j) on expenditure of a "private or domestic nature" is the most relevant).

- Section 105 provided for employment-related expenditure to be deemed to satisfy section 104, but did not exclude the application (in particular) of section 106(1)(j).

- Section 105 deemed expenditure of the kinds specified in the Fourth Schedule to be incurred in deriving income from employment.

- The section 106(1)(j) prohibition applied equally to sections 104 and 105.

- For expenditure covered by clause 8 of the Fourth Schedule a further test was that the expenditure must have been "for the purpose of, and a condition of" the employment.

- Because of the link from section 105 and the Fourth Schedule to section 104, and the link from section 106 to section 104, a claim for

expenditure under clause 8 was still subject to the private or domestic prohibition in section 106.

66. Therefore, section 104 was still the source of deductibility and section 106(1)(j) did not exclude section 105(2) expenditure. However, section 106(1)(j) did override section 104 (which included section 105(2) expenditure). This is consistent with the following extracts from *Haenga* (at page 5,203):

> 26 The final point about the statutory deduction framework that needs to be noticed is that s 106 bars certain deductions "notwithstanding anything in section 104". Deductibility in terms of s 105(2) is "For the purposes of section 104" and it follows that deductions in respect of income from employment must meet the requirements of s 106 as well as those imposed directly under s 105(2) and the material provisions of the Fourth Schedule. In that regard s 106(1)(j) bars deduction of "Any expenditure or loss to the extent to which it is of a private or domestic nature"
>
> 27 Applying that statutory scheme to the present case three requirements must be satisfied in order for these contributions to be deductible as such for income tax purposes:
>
> 1. they must have been "incurred by the taxpayer for the purposes of, and as a condition of, his employment ..." (Fourth Schedule para 8);
>
> 2. they must have been incurred by the taxpayer in gaining or producing that assessable income (s 105(2)(b)); and
>
> 3. they must not have been of "a private or domestic nature" (s 106(1)(j)).

67. The above sections and schedule of the 1976 Act were interrelated and provided a separate and distinct code of deductibility for salary and wage earners. This "regime" has since been repealed, and so, to determine whether the cases are still relevant to the exemption of salary and wage earners' allowances, it is necessary to consider the judgements in those decisions in detail. Also, these decisions dealt with items of expenditure that in the ordinary course might appear not to be deductible because of their private or domestic nature.

68. The facts of the three cases are as follows:

- *Haenga*: The taxpayer was an employee of the NZ Railways Corporation and during the 1982 income year claimed a deduction against his employment income for contributions he was required to make by statute to an employee welfare scheme. The welfare scheme was designed, like most similar schemes, to provide certain benefits to employees and their families mainly in respect of health care. Evidence before the Court indicated that membership to the welfare society "resulted in improved work performance and attendance" due to the security and relief afforded to members. This latter aspect appears to have been a significant factor in the Court's finding for the taxpayer.

- *Belcher*: Belcher was a senior university lecturer who undertook research work in the United Kingdom during her sabbatical leave and sought to claim a deduction against her employment income for travel to, from and about London and accommodation in London while conducting her research work. The Court heard that she was expected under her conditions of employment to "engage actively in research and to assist in promoting research". During the 1980 income year the taxpayer applied for, and was granted, special overseas leave to be spent mainly in London. The Court considered that in her circumstances she was contractually required to undertake the work for which the leave was approved. The Court noted that the type of research undertaken could have been carried out only in the United Kingdom; it was not possible to conduct that research in New Zealand.

- *Hunter*: The taxpayer was a police officer who applied for, and gained promotion to, a more senior position in another city. Because of this, he was required to transfer from Christchurch to Lower Hutt. In so doing he incurred expenses in moving over and above the amount reimbursed to him by the New Zealand Police and he sought to claim a deduction against his employment income for legal fees, land agent's charges and other costs arising from the sale of his family home and the purchase of a replacement property. A critical point in this case was the specific transfer requirements included in the New Zealand Police's *General Instructions on Transfer*. These instructions laid down strict conditions as to when an officer and his or her family could transfer; for example, it was not possible for the officer to take up his new position until he had established a home in the new city and moved his family with him. The Court saw this in contrast to other (state sector) employees on transfer who had options such as when they moved and whether their families moved with them. In other words, other employees had choices where police officers did not.

Case decisions

Commissioner's contention

69. In *Haenga* and *Hunter* the Commissioner's arguments were that the expenditures were of a private or domestic nature, and so were not deductible because of the application of section 106(1)(j) of the 1976 Act.

70. In *Belcher* the Commissioner first raised the private and domestic argument in the Court of Appeal. The Court rejected this late argument on the basis that it had not been raised in the lower court. Nevertheless, Richardson J went on to consider the argument and expressed the view that the expenditure in *Belcher* was not of a private or domestic nature.

Applicable law

71. All three cases were held to fall within the provisions of section 105 and clause 8 of the Fourth Schedule of the 1976 Act. (In *Belcher* there was some discussion as to whether some expenditure was more correctly deductible under clause 6, but this aspect of the case is not material to this discussion.)

The court ruled that in each case the expenditure was "for the purpose of, and as a condition of" each taxpayer's respective employment.

Substituted code for deductibility for salary and wage earners

72. The Court of Appeal considered the legislative framework and decided that section 105 and the Fourth Schedule of the 1976 Act was a substitute code of deductibility for section 104 of the 1976 Act, which applied when the taxpayer derived income from employment.

73. In *Hunter* Richardson J stated (at page 7,171):

> 6 It was noted in *Haenga* (NZTC p 5,207; NZLR p 128 [TRNZ p 50]) that the exclusion of expenditure made on private matters comes from the requirement of the first limb of s 104 (and s 105(2)(b)) which limits deductions to expenditure incurred in gaining assessable income, and the express inclusion in s 106(1)(j) may be regarded as having been inserted by way of precaution or emphasis. That links tests (1) and (3).
>
> 7 … And where that test is met the expenses are properly characterised as work related expenses: they are of an employment not a private or domestic character and deductibility in terms of s 105(2)(b) and the Fourth Schedule cl 8 involves a finding that deduction is not barred under s 106(1)(j) (*Belcher* NZTC p 5,171 NZLR p 717 [TRNZ p 120]).

74. It can be taken from the above that the Court determined that when the necessary connection existed between the expenditure and the income-earning process the expenditure had the "necessary nexus" to the income-earning process, and so could not be classified as being of a private or domestic nature.

The nexus test: purpose and condition of employment

75. The critical issue in all three cases was whether the expenditure came within the "purpose of, and a condition of, employment" test of clause 8 of the Fourth Schedule. If a sufficient nexus existed between the expenditure and condition of employment, and that expenditure was for the purpose of that employment, the expenditure was deductible.

76. In *Haenga*, the Court found that the expenditure had the necessary nexus to the income-earning process (the welfare society contributions were for the purpose, and a condition, of employment under the Fourth Schedule), so were not of a private or domestic nature. Richardson J said (at page 5,207):

> It is overly simplistic to brand these contributions to this welfare society as inherently of a private rather than an employment character. On the contrary, in the very unusual circumstances of this case I have come to the conclusion, not without hesitation, that the

> required nexus exists between the expenditure in question and the gaining of the employment income.

77. In *Belcher*, Richardson J considered that the costs associated with the taxpayer's overseas research had the necessary nexus to the derivation of income from the university. He said (at page 5,169):

> An expenditure does not exist in a vacuum. It is necessary to consider to what activity it relates. What is it for? If the taxpayer is performing a condition of employment, any expenditure appropriately incurred in doing so must I think be characterised as an expenditure incurred as a condition of employment. To put it another way, a condition that the employee do research necessarily extends to outlays required for that research. The first step is to determine whether the subject matter of the expenditure is a condition of the employment and, if so, the second is to determine whether there is a sufficient relationship between the expenditure and the income earning activity in respect of which it is incurred to warrant the conclusion that it was incurred as a condition of employment.

78. In *Belcher*, Richardson J noted that the adherence to *CIR v VH Farnsworth Ltd* (1984) 6 NZTC 61,770 precluded the Commissioner from raising the private and domestic argument as a new point having not been relied upon previously to support the assessment. He nonetheless stated (at page 5,171), consistent with *Haenga*:

> In any event there is no substance in the new point. As earlier noted the Authority held that all the expenditure was incurred by the taxpayer in gaining or producing her assessable income from the university within s 105(2)(b). That finding has not been challenged. And the finding under cl 6 is that the travel costs were incurred in the course of the taxpayer's employment and under cl 8 it is that other research expenses were incurred as a condition of and for the purposes of the employment. On that analysis these were work related expenses. They were of an employment, not a private and domestic character. As in (*Haenga)* the finding of deductibility under those provisions involves a finding that deduction is not debarred under s 106(1)(j).

Richardson J concluded that, in this case, the costs met the requirements of clause 8.

79. Similarly, in *Hunter* the Court concluded that the necessary nexus existed between the expenditure and derivation of the taxpayer's employment income.

Private and domestic argument

80. The Commissioner's main argument in each case was that the expenditure (the welfare society fees, cost of overseas travel and accommodation, and costs of moving home) was all of a private or domestic nature. However, the Court considered that if the necessary nexus existed and that expenditure was for the purpose, and a condition, of employment, then the expenditure could not be of a private or domestic nature (that is, section 106(1)(j) would not apply if the purpose/condition test was satisfied).

81. In *Haenga* Richardson J concluded his judgment, by saying (at page 5,207):

> Mr Jenkins [for the Commissioner] argued in the alternative that the outgoings in this case were of a private or domestic nature and therefore were not deductible under sec 106(1)(j). In some cases sec 105(2)(b) and section 106(1)(j) may raise different

> considerations but as has been foreshadowed the approach which I have taken to deductibility under the earlier provision parallels the yardstick expressly directed under the latter and any personal satisfaction derived from membership of the welfare society and the availability of benefits is only an incidental effect of the expenditure. *The finding of deductibility under sec 105(2)(b) involves a finding that deduction is not barred under sec 106(1)(j).* [Emphasis added.]

82. This theme was continued in *Hunter*, where his Honour said (at page 7,171):

> It was noted in *Haenga* ... that the exclusion of expenditure made on private matters comes from the requirement of the first limb of s 104 (and s 105(2)(b) which limits deductions to expenditure incurred in gaining assessable income, and the express inclusion in s 106(1)(j) may be regarded as having been inserted by way of precaution or emphasis.

83. That the taxpayer in *Hunter* was a "special case" in comparison with most other taxpayers, because of the special conditions of his employment, was noted by Casey J when he commented (at page 7,175):

> For these reasons the appellant was in a situation which was essentially different from that facing the generality of employees undertaking a transfer in the course of their work. They can normally make their own choice about the timing of their family move (if they decide the family should shift) and the type of accommodation. Here, these matters are prescribed and are so closely tied to the new appointment that I am satisfied that the appellant's expenditure in complying must be regarded as other than of a private and domestic nature, even though it is also associated with the continued existence of his domestic establishment.
>
> Having reached this conclusion, for the same reasons I have no difficulty in finding that the expenses were incurred for the purpose of and as a condition of employment, and were deductible under s 104.

84. As a point of difference, in *Belcher*, reference was made to an earlier High Court case (*C of IR v Mathieson* (1984) 6 NZTC 61,838) which had very similar facts to *Belcher.* In *Mathieson* the taxpayer was also a university lecturer who travelled to England to undertake research while employed by the university. Similarly, the taxpayer claimed accommodation costs over and above the reimbursement from the University, but the High Court agreed with the Commissioner's decision to disallow the claim. The distinguishing feature between these two cases was that in *Mathieson* the High Court judge determined that the research in England was not a "condition of his employment" – the taxpayer could have done the research anywhere – it was his personal choice to do the research in England. This being the case, the cost of accommodation did not meet the requirements of clause 8 of the Fourth Schedule, and the expenditure was of a private or domestic nature.

85. In *Belcher* the Court concluded (at page 5,171 per Richardson J) that:

> On that analysis these were work related expenses. They were of an employment, not a private and domestic character. As in [*Haenga*] the finding of deductibility under those provisions involves a finding that deduction is not debarred under s 106(1)(j).

This illustrates the point that when an expense **has the necessary nexus** to the derivation of the employee's income from employment, it is **not** of a private or domestic nature.

Current legislation

86. With the repeal of section 105 and the Fourth Schedule of the 1976 Act, the clause 8 requirement that the expenditure had to be for the purpose, and condition, of employment is no longer part of the legislative wording. However, as noted earlier, these Court of Appeal cases dealt with the deductibility of employment related expenditure which, under the 2004 Act, is now the test for deciding exemption under section CW 13 for these types of payments and allowances. Despite the legislative change, the cases are still useful in providing guidance for determining whether or not expenditure is of a private or domestic nature as that aspect was a critical factor which the Courts had to decide in each case.

87. The current legislation in relation to the exemption of such allowances and reimbursing payments is as follows:

- Section CW 13 exempts amounts paid by an employer in connection with that employee's employment or service when the expenditure:
  - was a payment of expenditure on account of the employee; and/or
  - reimbursed the employee for that expenditure; and
  - in either case (if it were not for the employment limitation) would be an allowable deduction to the employee.
- The employment limitation prohibits a taxpayer earning "income from employment" from claiming as a deduction any expenditure incurred in deriving that income. However, the operation of section CW 13 **ignores** the employment limitation in considering the exemption of allowances and reimbursing payments.
- Without the employment limitation, therefore, a taxpayer earning "income from employment" would have to rely on the general deductibility provisions of the 2004 Act for a deduction.
- The general deductibility provision in the 2004 Act is section DA 1. This section permits a deduction for an amount of expenditure or loss to the extent that it is incurred by the taxpayer in deriving the taxpayer's assessable income.
- However, this section is subject to a number of limitations in section DA 2 including the private limitation that excludes from deductibility any expenditure to the extent it is "of a private or domestic nature".

Interpretation of section CW 13

88. A requirement that must be satisfied before an employee allowance or payment can be exempt income under section CW 13 is that the expenditure incurred by the employee must be an allowable deduction to the employee but for the employment limitation.

89. In considering the application of the deductibility provisions that would apply to employee expenditure that may be seen as serving both private purposes and income earning, the applicable provisions are sections DA 1 and DA 2(2).

90. In the three cases (*Haenga*, *Belcher*, and *Hunter*), the Court of Appeal determined that if the expenditure was for the purpose, and a condition, of the income-earning process, the "sufficient nexus" test was met. This meant the expenditure was tax deductible and not of a private or domestic nature. Therefore, the same interpretation can apply equally to the current legislation because it involves such a nexus test and also requires determining whether expenditure is of a private or domestic nature.

91. To be deductible under section DA 1(1)(a) the expenditure, or the advantage sought by it, must be linked to the actual income-earning operations or activities. It is a matter of degree and so a question of fact to determine whether there is *sufficient* nexus.

92. The first step is to ascertain whether the expenditure *has the required type of relationship* to the operations and activities that constitute the income-earning process; that is, what did the employee do to earn income from employment?

93. The Commissioner considers that the case law discussed above gives useful guidance as to the circumstances in which expenditure should be considered to be deductible against employment-related income under section DA 1(1)(a) (if it were not for the private limitation). It follows that, if such expenditure meets these requirements, then that expenditure (if reimbursed by an employer), could qualify as exempt under section CW 13.

94. The essence of the Court of Appeal decisions can be encapsulated as being that a deduction will be permitted where the expenditure is in discharge of an obligation directly or indirectly imposed by the contract of service and, objectively, the obligation serves the purposes of the income-earning process. When these tests are met, deductibility extends to expenditure that is necessary as a practical requirement of the discharge of the obligation.

95. Consequently, the Commissioner has formulated the following three questions that, it is considered, will assist in determining the exemption of allowances and payments under the current legislation.

96. The questions are:

    (i) Was the employee performing an obligation under the contract of service at the time the expenditure was incurred?

(ii) Did the obligation serve the purpose of the income-earning process of deriving income from employment?

(iii) Was the expenditure incurred by the employee necessary as a practical requirement of the performance of the obligation?

If all three questions are answered in the affirmative, it is the Commissioner's view that the section CW 13 exemption would apply provided the expenditure for which the reimbursement is made is not of a capital nature (this capital exclusion is discussed later in the Interpretation Guideline).

97. As noted earlier, the courts did not expressly formulate these questions in relation to the legislation under which the three cases were decided. However, the cases are the most recent leading decisions in the area of the tax deductibility of employment-related expenditure and from them the Commissioner has formulated this set of questions that he considers compatible with the current legislation.

Practical application of section CW 13(2)

98. To illustrate the application of the three questions formulated above, they are applied to the following situation.

Motor vehicle mileage allowance paid to a travelling salesperson

99. A salesperson uses her own vehicle for travelling from town to town in the course of her employment. Her employer pays her a motor vehicle mileage allowance based on IRD approved mileage rates and a reasonable estimate of the average distance travelled each week on business as agreed between the parties.

The result of applying the three questions to the salesperson's example is as follows.

Question 1: Was the employee performing an obligation under the contract of service at the time the expenditure was incurred?

100. Yes. In this case the obligation is to perform the travelling sales' duties in terms of the employment contract.

Question 2: Did the obligation serve the purpose of the income-earning process of deriving income from employment?

101. Yes. In undertaking the travelling sales' duties the salesperson receives salary or wages, so the work is part of the income-earning process.

Question 3: Was the expenditure incurred by the employee necessary as a practical requirement of the performance of the obligation?

102. Yes. To undertake the duties of a salesperson, a motor vehicle is required and is not supplied by the employer. Costs associated with using the vehicle for business use (and for which the allowance is paid) flows from that need. The use of the motor vehicle is necessary as a practical requirement of the salesperson's occupation.

Conclusion

103. Having answered all three questions in the affirmative, the motor vehicle mileage allowance would be exempt from tax under section CW 13 subject to the expenditure not being of a capital nature. It is clear from the case law that this type of allowance is exempt because the expenditure incurred by the employee is deductible (were it not for the employment limitation) as being expenditure incurred "in the course of employment" (that is, while doing the work). Therefore, it was incurred in producing the employee's income.

Allowances or Reimbursements that could be seen to be of a Private or Domestic Nature

104. There are other allowances or reimbursements paid to employees where it may be more difficult to apply the three questions because, at least initially, the allowances or reimbursements could be seen to be of a private or domestic nature. As noted earlier, this Interpretation Guideline now considers some of the more common types of allowance or reimbursement, namely payments in respect of meals, clothing, and home relocation.

Meal allowances and reimbursements

105. Case law, both in New Zealand and overseas, generally supports the proposition the expenditure on meals is of a private or domestic nature, and so is not an expense necessarily incurred in deriving income. Meal costs are regarded as a normal part of living rather than as being necessary in the production of income. As far as employees are concerned, the courts have consistently rejected meal expenditure generally on the basis that such costs are not incurred "in the course of employment".

106. In normal situations the employee is not deriving income while eating a meal. However, in some particular situations the courts have determined that a meal cost was deductible. In these situations there was found to be a direct nexus between the cost of the meal and the income-earning process.

107. The following examples consider scenarios relating to the payment of meal allowances or the reimbursement of meal costs.

Example A: overtime meal allowance[1] - standard overtime.

[1] For the purposes of the following discussion, "overtime meal allowance" includes any meal allowance paid during a period an employee is paid penal rates, night rates, or shift work rates.

108. Employee A is a motor mechanic who is required as part of the terms of the employment contract (that is, it is not a choice) to work overtime until 8 pm on a particular day. The employee's normal finishing time is 4.35 pm and the employee is paid at overtime rates for the period worked up to 8 pm. The employee works until 5 pm before taking a half-hour meal break. A $14 meal allowance is paid to the employee who may use it to purchase an evening meal.

109. In these situations it is generally not a requirement of the employer that the employee actually spend any of the allowance on a meal during the half-hour break. The employee could just as easily bring food from home to eat or delay the consumption of the evening meal until he or she returns home after the overtime. It is the employee's personal choice.

Question 1: Was the employee performing an obligation under the contract of service at the time the expenditure was incurred?

110. Yes. Employee A is doing the work that he is contracted to do (that is, repairing motors). The employee, in working during the overtime period, is carrying out an obligation under his employment contract.

Question 2: Did the obligation serve the purpose of the income-earning process of deriving income from employment?

111. Yes. The overtime will have generated income that is assessable income. Therefore, working the overtime, as requested, served the purpose of the income-earning process. .

Question 3: Was the expenditure incurred by the employee necessary as a practical requirement of the performance of the obligation?

112. No. The employer paid the employee an overtime meal allowance of $14, as provided for in the employment contract, for the purpose of purchasing the employee's evening meal. This is because, generally, it is impractical for an employee to go home for the usual evening meal in the time provided. It is arguable that the employee would have had to have a meal whether he or she worked overtime or not. The expenditure on the meal would not be incurred "in the course of employment" in the sense that while having the meal the taxpayer would not be deriving income.

Case law

113. In *F v Commissioner of Taxes* (1943) 3 MCD 277 (the only New Zealand case that specifically deals with a deduction for "overtime meals") a waterside worker claimed the cost for meals taken when he was required to work overtime.

114. The meal was taken between the time the taxpayer ceased normal work hours and before overtime work commenced. The taxpayer's ordinary hours of work

were 8 am to 5 pm. He was obliged to work overtime when called to do so. The taxpayer did not receive notice to work the overtime on any day until about 3.45 pm. Therefore, he was unable to notify his wife that he would not be home for his usual evening meal. This necessitated the purchase of a meal in town by the taxpayer.

115. The Magistrate disallowed the claim because he determined that the taxpayer was not engaged "in the course of employment" when he ate his evening meal. The court ruled that a taxpayer must prove that the expenditure was incurred in the course of something done in the course of his employment. The court held (at page 280) that "as a rule" you cannot "eat or sleep" in the course of performing duties.

116. The Magistrate also noted that a factor necessitating the purchase of the meal was the distance between the taxpayer's home and his place of work. The Magistrate said (at page 279):

> I also find as a fact that the necessity to purchase the evening meal would not have arisen but for the location of the appellant's home. The distance between his place of work and his residence precluded him from having his evening meal at home in the ordinary way. His travelling-time alone would have exceeded the time allowed for the meal.

While this case is now dated, it was cited with approval in Taxation Review Authority (TRA) case (*TRA Case A12* (1974) 1 NZTC 60,088).

117. In *TRA Case A12* the taxpayer was a part-time polytechnic tutor who purchased meals between finishing his full time job as an accountant and commencing work at a polytechnic, because he did not have enough time in the intervening period to travel home for his usual evening meal.

118. The TRA disallowed the claim as the meals were not a necessary expenditure to enable him to earn income and constituted expenditure of a private nature. As the meals were consumed after the completion of one job but before the commencement of the other they were not incurred "in the course of" either of the two jobs.

119. In the United Kingdom case of *Sanderson v Durbridge* [1955] 3 All ER 154 the taxpayer was employed by a local authority. His duties included evening attendances at council committee meetings and he had to buy an evening meal at a restaurant between the time he finished his normal duties and the start of the evening meetings.

120. The court disallowed the claim for the cost of the meals as the taxpayer "could not be said to be engaged in the performance of his duties when he was having his dinner". Wynn-Parry J said (at page160), "I can see no difference for myself in principle between the nature of the interval for lunch and the interval for tea or the interval for dinner".

121. In *TRA Case L38* (1989) 11 NZTC 1,234 an employee incurred costs for meals in between business meetings and on the way to the airport to fly to business destinations. The TRA disallowed the deductions on the basis that

they were of a private or domestic nature. Barber DJ commented (at page 1,237):

> I have explained in a number of other cases over the past year that, generally, expenditure for a person's own meal is of a private rather than business character because, as human beings, we need food intake in order to live. I cannot be satisfied from the evidence of the objector that this item is business-related.

122. These cases clearly indicate that the courts and tribunals will not accept as an allowable deduction costs in respect of meals taken by salary and wage earners between the end of normal work hours and the commencement of overtime or between two jobs or, as in the circumstances of *TRA Case L38*, costs incurred by an employee on meals between business engagements and while in the course of travelling to business engagements.

123. It is implicit in these cases that, while the courts saw the distance the taxpayer lived away from work contributed to the need to purchase meals because there was insufficient time for the taxpayers to go home for their normal meals, that aspect did not alter the private nature of the expenditure.

Conclusion

124. It is the Commissioner's view that the overtime meal allowance paid in example A is not related to expenditure that is "necessary as a practical requirement" in undertaking the overtime work in the relevant sense. As noted by the courts the expenditure was not incurred in the course of deriving the income. Therefore, as question 3 cannot be answered in the affirmative, the overtime meal allowance will not be exempt from income tax under section CW 13(2).

Example B: overtime meal allowance – non-standard overtime.

125. Employee B is a motor mechanic who is not required to work overtime by his employer. There is no mention of overtime in employee B's employment contract. However, a customer of the employer needs work on a motor car completed urgently. The employer asks employee B to stay behind after normal hours to do the job. The employer agrees that during the overtime period the employee may take a meal break and will be paid a meal allowance to purchase the meal in town.

126. The three questions applied to employee A apply equally to employee B. The employee is doing the work required under the employment contract. In doing that work the employee is receiving salary or wages that form part of his income. However, the eating of the meal during the work break is again not "necessary as a practical requirement" to the work employee B is doing in deriving the income from working the overtime.

Conclusion

127. The cost of the meal reimbursed by the employer to employee B will not be exempt from tax in the hands of the employee.

Example C: meals while entertaining business clients

128. Employee C is a salaried sales representative for an engineer consultancy company. During a visit by clients from another city she is asked by her employer to entertain the clients at a nearby restaurant with drinks and food before the clients catch a flight back to their home city. Employee C paid the restaurant account with her credit card and the following morning submitted an expense claim to the employer (as earlier agreed by the employer) who subsequently reimbursed Employee C for the total amount of the restaurant account.

Question 1: Was the employee performing an obligation under the contract of service at the time the expenditure was incurred?

129. Employee C was carrying out the duties of a sales representative as required by her employer. It is not necessary that an employment contract specifically states every duty or task an employee may be required to perform. When an employer and employee agree that additional duties will be carried out, and those duties serve the purposes of deriving assessable income, then this requirement will be met.

Question 2: Did the performance of the obligation serve the purpose of the income-earning process of deriving income from employment?

130. By performing the duties of a sales representative, which includes when required entertaining the employer's clients, employee C derived income subject to income tax.

Question 3: Was the expenditure incurred by the employee necessary as a practical requirement of the performance of the obligation?

131. Employee C was eating a meal while, and as part of, performing her employment duties as directed by her employer. The Commissioner considers that the cost associated with the entertainment of the business's clients, in this case, is necessary as a practical requirement relating to the derivation of the employee's income. The meal was not part of the ordinary living expenses of a private individual.

[Note the above example deals specifically with the application of section CW 13(2). It does not consider any limitation under the entertainment expenditure regime in subpart DD which may limit the exemption to the employee to 50% of the amount reimbursed.]

Case law

132. In *TRA Case L38* some of the claims related to discussions with business colleagues or entertaining business clients. Judge Barber allowed such claims on the basis that they were "business related", so the reimbursement payments

for the cost of these meals were exempt in the hands of the employee taxpayer.

Conclusion

133. It is Commissioner's view that the expenditure on meals while entertaining business clients (as incurred in example C) would be deductible to the employee if it were not for the employment limitation. Therefore, the reimbursement by the employer to the employee would be exempt from tax under section CW 13.

Example D: meals taken in association with accommodation while absent from home

134. Employee D is required by his employer to attend a two-day annual industry conference in a city other than the employee's home town. The employee is required to travel to the conference the day before the conference starts, because the conference starts early on its first day. The employee books into a hotel for two nights and has all his meals over the ensuing two days at the hotel. He pays the hotel invoice on checking out. The employer reimburses the employee for the total cost of the hotel on the employee's return to work.

Question 1: Was the employee performing an obligation under the contract of service at the time the expenditure was incurred?

135. Employee D was carrying out the duties as required by the employer, which included attending the conference.

Question 2: Did the performance of the obligation serve the purpose of the income-earning process of deriving income from employment?

136. By attending the conference the employee was undertaking the obligation and duties for which he derived his income from employment.

Question 3: Was the expenditure incurred by the employee necessary as a practical requirement of the performance of the obligation?

137. The Commissioner considers the hotel costs in this case were necessary as a practical requirement in deriving the income from employment. The expenditure was incurred during the course of the employee's employment, which extends from the time he departed the town in which he worked and resided until his return to the town after the conference.

Case law

138. In *Watkis (HMIT) v Ashford Sparkes & Harward* [1985] 2 All ER 916 the Court considered a variety of meal situations. This case concerned the meal and accommodation costs of partners in a firm of solicitors. The claim related to three categories of expenditure:

(a) Refreshments for the partners at the lunchtime local office meetings, at weekly or fortnightly intervals, attended by the partners who operated at the offices concerned.

(b) Meals at "plenary evening meetings" of which there were six in 1979, attended by all the partners.

(c) The firm's annual conference which was held at the Marine Hotel on Saturday and Sunday, and which was attended by partners together with their families.

The expenditure in items (a) and (b) were disallowed. The Court noted (at page 927) that "lunchtime and evening meals were provided at times that the partners would have normally eaten lunch or dinner anyway … The taxpayers need food or drink irrespective of whether they are engaged on a business activity".

139. The meals and accommodation for the partners at the annual conference held at a hotel were determined to be allowable as income tax deductions. In relation to the conference the Court said (at page 933):

> I do not think that the cost of accommodation can necessarily be said to have been expenditure which meets the needs of the taxpayers as human beings. They did not need it for that purpose because they had their own homes where they could have spent the night. The reason why they needed it was so they could continue their discussions of the particularly important topics informally between the formal sessions on the Saturday afternoon and the Sunday morning. If they had to break up and go home after dinner on the Saturday evening and come back on the Sunday morning, that continuity, which was of considerable importance and value, would have been broken or at least seriously damaged … In my view there is no distinction between the cost of overnight accommodation on the one hand and food and drink on the other.

Notwithstanding that this case involved partners in a firm rather than employees, it is relevant to note the distinction the Court drew between the conference related meals and accommodation, and the meals taken by the partners at lunch time, local office meetings and plenary evening meetings.

140. It is clear that the Court saw the meals at the lunch time and evening meetings as being a replacement for the meals the partners would have to take in any event, being meals "to meet the needs of the taxpayers as human beings". At the annual conference, when the partners were staying away from home, the meals were linked to, and were part of, the cost of the accommodation. In this respect, the decision to allow the claim is consistent with the substantial majority of decisions by the courts that have permitted deductions for meals taken as part of accommodation while the taxpayer is away from home overnight.

Extra costs of meals

141. The extra cost of a taxpayer's meals was considered in *Caillebotte (HMIT) v Quinn* (1971–1977) 50 TC 222. The taxpayer in this case was a

subcontracting carpenter who worked at various sites within a 40-mile radius of his home. The taxpayer maintained he could not go home for lunch when working at these sites and claimed a deduction against income for the extra cost of the meals taken away from home against the estimated cost of meals that he would have incurred if he had had the meal at home. The court disallowed the claim on the basis that no part of the cost of the lunches was exclusively expended for the purposes of the taxpayer's business.

142. On the question of apportionment of meal costs (the difference between what the taxpayer spent on lunches away from home and what he would have spent had he been able to eat at home) the Court said (at page 227):

> This attempt to apportion discloses the duality of purposes that is fatal under sec. 130. It is not possible to divide up a meal or the expenses of a meal so that the first sandwiches or the first 10p. are attributable to Mr Quinn and the residue to his business. Nor do I accept the logic of the suggested method of apportionment. No one has a divine right to work and eat at home, or to eat at his place of business, or to measure the cost of his appetite by the cheapest method which would have been available to him if he had chosen to conduct his business in some other fashion than that which he in fact chooses.

When discussing the apportionment of such costs as travel and the cost of the use of a room for business purposes, Templeman J noted (at page 227):

> But it is not possible to apportion a meal. Thus in *Bentleys, Stokes & Lowless v Beeson* (1952) 33 TC 491 all the costs incurred by solicitors in entertaining clients were allowed when it was shown that the only purpose of the entertainment was to promote the business of the solicitors.

143. Therefore, it is not possible to deduct for tax purposes the additional costs of meals when compared with the cost of a meal taken at home. Where the meal costs have been correctly determined as being deductible, the taxpayer can claim the full cost of the meal without any adjustment for the notional cost of a meal taken at home.

Conclusion

144. The general weight of the authorities on the deductibility of meal costs leads the Commissioner to the conclusion that, in general, meal costs will be of a private or domestic nature. Only when the meal is taken as part of some business activity such as entertaining clients or business associates or in association with accommodation while the taxpayer is absent from home on business, will the Commissioner agree to allowances or reimbursements being exempt from income tax under section CW 13.

145. In summary, the Commissioner considers that the following reimbursements of meal costs, where the employee pays the cost of the meal, will only qualify for exemption under section CW 13 where:

- Meals are taken as part of business or work meetings.
- Meals are taken as part of the entertainment of business clients.

- Meals are taken by the employee when absent from his or her normal home for attending a business conference or meeting where that absence necessitates the employee being absent from home overnight.

Longer term absences from home

146. Sometimes an employee will be absent from his or her home (and usual workplace) for extended periods, such as when on secondment to another branch of the employer's company. In these situations the employee may receive allowances or reimbursing payments to cover the additional costs he or she incurs when living away from home.

147. It is clear that such allowances or reimbursements form part of the employee's income. The definition of "salary and wages" in section OB 1 includes the market value of the benefit of employer-provided "board or lodging, or the use of house or quarters".

148. This raises the issue of whether these allowances or reimbursements should also be exempt from tax on the basis of the legal authorities on meals and accommodation in the context of short-term absences from home.

149. As already noted, the costs of everyday living, food, and shelter are of a private and domestic nature, so not deductible for income tax purposes. However, the courts have made it clear that costs associated with accommodation and meals when the employee is absent from home, on work, for relatively short periods can qualify as being tax deductible.

150. When the absence from home is longer (for example, when an employee is on a long-term secondment), do the same rules apply to exempt any payments made to the employee to meet additional costs? It is the Commissioner's view that in the extended absence situation (for example, a long-term secondment) the issue can be answered according to whether the employee has shifted his or her home base. "Home base" in the context of this discussion is the place where, for the time being, the employee has established a new home and from where the employee travels to and from to the new workplace. If the employee has shifted his or her home base, the costs of food and accommodation incurred by the employee will form part of the employee's income under the definition of salary and wages and will not be exempt from tax.

151. Whether an employee has changed his or her home base (in relation to the new workplace) will determine if the associated costs are considered to be necessary as a practical requirement to the performance of the employee's obligations under the employment contract, or should instead be regarded as private or domestic expenditure.

152. Each case needs to be considered on its facts, but the following factors may be relevant in determining whether the employee has established a new home base from where they attend (on a daily basis) the new workplace:

- The length of time the employee is absent from the employee's usual workplace.

- Whether the employee has moved his or her family to the new work location.

- Whether the employee has severed ties with his or her former home base (that is, whether the home has been sold or let during the secondment).

153. The Commissioner considers this approach is consistent with the tenor of several court decisions (discussed above) and with the view expressed in *TRA Case M128* (1990) 12 NCTC 2,825. In that case the TRA rejected a taxpayer's claim for the costs of rent and food while living away from his normal home for work purposes. Barber DJ said (at page 2,837):

> However, the rental and associated expenses which the objector incurred, do not have a sufficient connection with his employment process to achieve deductibility. The employer merely required that he perform his job in the cities in question. Such aspects as to where he lived, or where his family lived, were quite unrelated to the operation of the employment work. I am in no doubt that all these expenses were of a private or domestic nature. To use the words of Richardson J in *Haenga* p 5,207 … they were of a private nature because they are "exclusively referable to living as an individual member of society" and domestic expenses are "those relating to the household or family unit".

154. The following examples set out how the Commissioner would approach various situations in this context. It should be noted that the conclusions reached are only indicative of the Commissioner's view. As noted earlier each case will need to be considered on its own facts.

Example E: temporary transfer

Situation

155. A married employee is temporarily transferred to another branch of his employer for 2 months. His family stays in its present location in the family home.

Comment

156. Because of the employee's relatively short time absent from home, it is more than likely that the employee has not moved home. His home base remains at the location where his family lives.

Taxation consequences

157. Allowances or reimbursements of a reasonable amount paid to the employee in respect of accommodation and food in respect of the employee's stay in the away location will not be subject to tax.

Example F: long-term secondment

Situation

158. An employee is seconded to a new location with the same employer for 2 years. Her family moves to the new location with her and has temporarily rented out the family home. Her employer pays her an allowance so the employee and her family can rent a house at the new location where they live for the secondment's duration.

Comment

159. Because of the length of the secondment, it is likely that the employee has re-established her home base to the new location from where she travels each day to the new work site.

Taxation consequences

160. The allowance the employee receives from her employer will be subject to tax.

Example G: change of home base

Situation

161. An employee is a single person who usually lives at home with her parents. The employee is seconded with the same employer to another city for 4 months and accommodated in a motel unit, the cost of which is recompensed by the employer.

Comment

162. The employee has most likely re-established her home base to the new location for the secondment's duration.

Taxation consequences

163. The amount the employer pays to the employee for the motel accommodation, together with any allowances in respect of food and incidentals will be assessable income to the employee (and not exempt from tax).

164. As intimated in the above examples, the question of assessability or exemption of allowances or reimbursements made in these circumstances will need to be considered on their own facts. The above examples are intended to give some guidance in this area.

Clothing expenditure

165. Expenditure on clothing is another area where it may need to be determined whether an allowance paid to an employee is exempt from tax under section CW 13. Expenditure incurred in the purchase, maintenance, or repair of clothing is generally not deductible as the expenditure is normally considered to be of a private nature. However, clothing expenditure may be allowed in certain circumstances.

166. Broadly, allowable clothing expenditure, in the context of this Interpretation Guideline, can be separated into three types that the courts have considered for deductibility purposes:

- expenditure on **protective** clothing or footwear;
- expenditure on a **uniform** or **special** clothing in the nature of a uniform; and
- **abnormal expenditure** on conventional clothing.

167. The deductibility of the first two types of clothing expenditure is reasonably well recognized by the courts as being employment related, so these types are not considered in any detail.

Protective clothing

168. Generally, clothing or footwear that is purchased for protective reasons and worn (generally) over or in addition to conventional clothing has been regarded as deductible for income tax purposes (in the absence of the employment limitation), and so any allowance paid to an employee to cover the cost of such protective clothing items will qualify for exemption in terms of section CW 13.

Uniform or special clothing in the nature of a uniform

169. Similarly, the purchase and maintenance of a uniform, or special clothing in the nature of a uniform, has been accepted as prima facie deductible for tax purposes. However, the courts have generally rejected claims for conventional items of clothing (such as ordinary white shirts, socks and shoes) worn in conjunction with a uniform.

170. In the Australian case *Case 54* (1957) 7 CTBR (NS) 419 involving an Australian naval officer, the taxpayer was allowed a deduction for expenditure on his tropical wear uniform of shorts, shirts, white shoes, etc., but not on the white shirts, black shoes, socks, etc., that comprised his non-tropical uniform. These items were no different from normal menswear.

171. In *Case C30* (1978) 3 NZTC 60,283 a policeman had to purchase black lace-up shoes of a style suitable for wearing with his uniform. It was held that even though the shoes formed part of the uniform, they were conventional in that they could be worn with civilian clothing.

Abnormal expenditure on conventional clothing

172. The courts have also on occasions allowed deductions for conventional clothing when the taxpayer has incurred **abnormal expenditure** on conventional clothing, because of the taxpayer's occupation.

173. The "abnormal expenditure on conventional clothing" test has been considered under two distinct headings:

- "abnormal wear and tear on clothing"; and
- a need for a "greater quantity" of clothing.

Case law

174. The "abnormal wear and tear on clothing" situation occurred in *Beckett v CIR* (1981) 5 NZTC 61,078. In this case a plain-clothes police officer, working on the waterfront, was allowed a deduction for additional suits and dry cleaning because of the particular dirty and hazardous conditions under which he was employed.

175. Additional clothing costs, because of a need for a "greater quantity" of clothing, were allowed in *Case 31/93* 93 ATC 359. In that case the personal assistant to the wife of a high-ranking government official was permitted a deduction for the increased cost of her conventional clothing, because she needed clothing to complement that worn by her employer to official functions.

176. The above is consistent with the general weight of case law on clothing costs. For example, in *Hillyer v Leeke (HM Inspector of Taxes)* (1973-1978) 51 TC 90 the court found against the taxpayer who was required by his employer to wear a suit when visiting the employer's clients. The Court determined that the cost of a suit or suits was not " wholly and exclusively laid out for the purpose of trade, profession or vocation" (the wording of the United Kingdom legislation).

177. In New Zealand, Barber DJ set out the tests for determining deductibility of conventional clothing expenditure in *TRA Case F46* (1983) 6 NZTC 59,792. This case allowed a band member's claim for the cost of clothing he purchased specifically to wear when performing with the band. The TRA noted that the clothing was conventional "female clothing" that the male band member wore only on stage. Barber DJ stated (at page 59,797):

> … The expenditure in question must have the required statutory connection with the income earning activity and yet not be of a private nature — refer *Case K2* 78 ATC 13. Accordingly counsel for R submitted, whether those hurdles can be successfully negotiated by O depends upon whether his particular circumstances fall within either of the two recognised tests which have evolved from the Australian cases. In this latter respect counsel for R referred me to *Case A45* 69 ATC 270 which, as he so rightly said, is worth reading to refresh one's memory on the law relative to this issue.
>
> The first test is the "necessary and peculiar" principle where expenditure is on clothing necessary and peculiar to an occupation. The second test is where the taxpayer, by virtue of his occupation, has been required to incur "abnormal expenditure on conventional clothing".

178. In *Case A45* (referred to above) the second test was described in more detail as:

> a deduction may be allowable in respect of expenditure on clothing where in his occupation a taxpayer is under a recognised obligation to provide himself with a wardrobe of conventional clothing which is *quantitatively in excess of what might be regarded as normal everyday requirements*, or where the exigencies of the particular occupation require replacement of conventional clothing more frequently than would be regarded as normal. This test may be shortly described as "the abnormal expenditure on conventional clothing" test. [Emphasis added.]

Example H: Clothing costs

179. A taxpayer is employed as a policy analyst by a government department. Part of his duties requires him to meet with the relevant Minister of the Crown to discuss policy issues. A requirement of his employment conditions is that he must wear a suit to work, and when meeting with the Minister.

Question 1: Was the employee performing an obligation under the employment contract at the time the expenditure was incurred?

180. Employee H was employed as a policy analyst in accordance with the employment contract.

Question 2: Did the performance of the obligation serve the purpose of the income-earning process of deriving income from employment?

181. The employee derived income from performing his duties as a policy analyst with the government department.

Question 3: Was the expenditure incurred by the employee necessary as a practical requirement to the performance of the obligation?

182. Employee H's duties required him to undertake policy work under the employment contract. He was paid to do that work and the requirement to wear a suit (conventional clothing) does not affect his ability to do that work. The cost associated with wearing a suit to work is not necessary as a practical requirement in deriving assessable income as the employment need does not go beyond reasonable normal work clothing requirements. Therefore, any allowance or amount paid by the employer to the employee in respect of these conventional clothing costs would not be exempt under section CW 13.

183. It is clear that the employee in example H has not incurred expenditure "quantitatively in excess" of what is generally accepted as being the normal attire for a person working in the same or similar occupations. There is unlikely to be any excessive wear and tear on the employee's clothing as in *Beckett.* The employee in example H would not be entitled to an exemption in respect of any allowance paid by the employer in respect of the clothing requirements.

Conclusion

184. Based on the above analysis, the Commissioner considers that the following allowances or reimbursements of clothing costs, where the employee pays for the cost of the clothing, will only qualify for exemption under section CW 13 where:

- the expenditure is in respect of **protective** clothing or footwear; or
- the expenditure is in respect of a **uniform** or **special** clothing in the nature of a uniform; or
- **the employee incurs abnormal expenditure** on conventional clothing due to excessive wear and tear or the need for a greater quantity of conventional clothing.

Employee relocation reimbursements

185. Relocation can involve the transfer of existing employees within an organisation and the relocation of a new employee to be near the new work site. Existing employee relocation takes place for several reasons, varying from the employer's operational requirements to the employee's personal preferences. Typically, the employer reimburses the employee for the costs of selling and buying the family home and moving to the new location. Individual costs incurred in these moves may include real estate agents' commissions in selling an employee's home and purchasing a new home, solicitors' fees associated with the selling and the buying of the homes, the costs of moving the family furniture and effects, the costs of travel by the taxpayer and family to the new location, and (in some cases) the cost of temporary accommodation in the new location while the family is waiting to move into their new home. This raises the question as to whether such expenditure or employer reimbursements are exempt from tax under section CW 13 as, essentially, this type of expenditure or reimbursements could be seen to be of a private or domestic nature. It also raises the question as to whether such expenditure could be seen to be of a capital nature. This is discussed later in this Interpretation Guideline.

Case law

186. Two cases decided by the TRA considered the deductibility of costs associated with employees taking up employment at a new location and both were decided in favour of the Commissioner, who sought to disallow the costs claimed as deductions.

187. *TRA Case E49* (1982) 5 NZTC 59,289 concerned an employee of a local body in one city (DN), resigning from that position to take up a job with another local body in another city (HL). In his 1980 income tax return the taxpayer relied on clause 8 of the Fourth Schedule of the 1976 Act to claim a deduction for the legal costs and estate agent's commission paid in relation to selling the former home and buying a new home near the new work location.

188. While this case focused on whether the requirement of the employee to move residences was a "condition" of his new employment as required by clause 8, Barber DJ did determine, that in terms of section 104, he could not find "sufficient nexus in this case between the expenditure and income". The judge cited Richardson J in *CIR v Banks* (1978) 3 NZTC 61,236 at page 59,292:

> [that to qualify for a deduction the taxpayer must show that the expenditure was] incurred in gaining or producing [assessable income] … There must be the statutory nexus between the particular expenditure and the assessable income of the taxpayer claiming the deduction.

His Honour concluded (at page 59,292):

> I find that O's expenditure … was not incurred in gaining or producing assessable income for any income year. It was private or domestic expenditure in terms of sec. 106(1)(j) to enable O to live in an area from which he could readily travel to his place of work on a day-to-day basis. My overall rationale then is that while the costs on the DN sale and the HL purchase may have been "expenditure … for the purposes of … employment" they were not a "condition" of employment; there is no sufficient nexus between the expenditure and the gaining of income; and in any case the expenditure is of a "private and domestic nature" under sec. 106(1)(j).

189. *TRA Case F99* (1984) 6 NZTC 60,045 also concerned a claim for transfer expenses by an employee resigning a position in Wellington and taking up a new job with a new employer in Auckland. Barber DJ concluded that the taxpayer's expenditure was not incurred in gaining or producing assessable income. The expenditure was made for the purpose of getting to work rather than in the course of employment, so was not deductible. A point in this case was that the taxpayer did not sell his Wellington home and buy another in Auckland until some time after he had taken up employment in Auckland. This supports the contention that the timing of the move is not critical in these cases. It is whether the expenditure is incurred in the course of the employment that is relevant when considering the deductibility of an employee's transferring expenses.

190. Expenditure incurred before the commencement of the income-earning process is not incurred "in the course of employment". A further point (see *TRA Case E49)* is that the expenditure is of a private or domestic nature, so is debarred from deduction against income from employment (if it were not for the employment limitation).

191. In examples I, J, and K, below, the three questions developed earlier in this Interpretation Guideline are applied to three home relocation situations.

Example I: home relocation – new employer

192. Employee I is an office manager who takes up employment with a new employer. The employee moves home to the new work location and incurs expenditure in relocating the home to the new work location. The new employer offers to reimburse the new employee for actual (or estimated) costs associated with the relocation.

193. When the employee taxpayer finds employment with a new employer in a locality different from that in which he or she lives, and the taking up of that employment requires the employee to move residences, will the costs of an employee moving to a new employment in a new location have the necessary nexus to the gaining of income from employment? In order to answer this it is necessary to consider the three questions formulated in this Interpretation Guideline.

Question 1: Was the employee performing an obligation under the contract of service at the time the expenditure was incurred?

194. The obligations to be performed by the employee, under the new employment contract, consist of the work the employee is employed to do in relation to the new job. These are the obligations that relate to the employee's income-earning process. That is, the actual work the employee does to earn his or her income from salary and wages. The employee will not be performing these obligations (in this example, management duties), until the day he or she shows up at work at the new location and commences earning income. Therefore, any actions (for example, shifting home and any expenditure incurred in relation to those actions) taken by the employee before starting work are in relation to getting to work rather than performing the obligations related to the new job.

Conclusion

195. Having concluded that the first of the three questions has not been answered in the affirmative, it is not necessary to enquire further. For the second and third questions to apply, the first question must be answered affirmatively. Therefore, the reimbursements or amounts made to the employee will not be exempt from tax under section CW 13.

Example J: home relocation - under the terms of the employee's contract

196. Employee J's employment contract requires employee J to transfer at the employer's request at any time. Employee J is posted to another location in the same job (that is, as an office manager) and relocates her home to the new work location. The employee is doing the same job before and after the transfer. The employer offers to reimburse employee J for actual (or estimated) costs associated with the transfer.

Question 1: Was the employee performing an obligation under the contract of service at the time the expenditure was incurred?

197. Employee J was, under the employment contract, performing management duties at the new location when and where directed.

Question 2: Did the obligation serve the purposes of the income-earning process of deriving income from employment?

198. The requirement to move locations on the employer's direction directly related to the continuation of an income stream – the derivation of salary and wages for employee J – the transfer served the purpose of the income-earning process.

Question 3: Was the expenditure incurred by the employee necessary as a practical requirement of the performance of the obligation?

199. On the basis that it is a contractual requirement under the employment contract to undertake management work where directed, and the performance of the obligation of the job requires the transfer, it seems more likely that the costs of transfer will have the necessary nexus to the employee's income-producing process. It is considered that this result is consistent with the decision in *Belcher* where the employee was required to carry out certain research that could be done only in the United Kingdom. In this example it was necessary for the employee as a practical requirement (to incur the relocation costs) in the performance of the obligations under the employment contract to move to the new location when directed.

Conclusion

200. In this situation it is considered that affirmative answers can be given to all three questions to arrive at the conclusion that any reimbursements made to employee J to cover costs relevant to the relocation would be exempt from tax. This is subject, of course, to the expenditure for which the reimbursement is made not being of a capital nature. Whether any such expenditure is of a capital nature is discussed in more detail later.

Example K: home relocation – for a new job with the same employer

201. Employee K applies for a new job at another branch of his existing employer's organisation. Employee K will be covered by a new employment contract with his existing employer if he is successful in his application for the new job. The purpose of applying for the new job is to enhance the employee's prospects within the employer's organisation by putting the employee in a more favourable position for future promotion and ultimately higher income. Employee K is appointed to the new job. Employee K relocates his home to the new location. The employer offers to reimburse employee K for actual (or estimated) costs associated with the relocation.

Question 1: Was the employee performing an obligation under the contract of service at the time the expenditure was incurred?

202. The obligations and duties performed by employee K, under both employment contracts with the same employer, consist of the work the employee is

employed to do in the jobs at the old and new locations. These are the obligations that relate to the employee's income-earning process. The employee will not be performing these obligations in relation to the old job because the relationship with the old job has ended. In relation to the new job any actions (for example, relocating his home) taken by the employee before starting work at the new location are in relation to getting to work, rather than performing the obligations related to the employee's new job.

203. Example K would appear to be analogous to the situation in *Hunter* where the Court of Appeal allowed a deduction for some of the costs associated with the transfer of a police officer. However, the Court noted that the situation in *Hunter* was essentially different from that facing the "generality of employees". Casey J stated at page 7,175:

> *In the ordinary course of human affairs the sale of one family home and the purchase of another, and the associated expenditure on solicitors and land agents, will generally be regarded as private or domestic transactions, whether or not they are motivated by employment considerations*. But the cost of relocating a taxpayer's domestic establishment may call for separate analysis if, as contended here, it was incurred as a requirement of his employment and at his employer's direction. (I use the words "employment" and "employer" as aptly describing the relationship between the appellant and the Police Department.)
>
> The Authority found that he was required to transfer in the course of his duties as a police officer. The Department's memorandum advising of his appointment and promotion stated:
>
> 3. A Police residence, if available, will be allocated to the member by the District Commander, Wellington.
> 4. If there is no Police residence available at Wellington for the member's occupation he will be required to make immediate application for an allocation of a pool house or alternatively make his own accommodation arrangements.
> 5. The member's transfer and the removal of his household and effects are not to be actioned until he has arranged suitable accommodation at Wellington which is vacant and ready for his occupation.
> 6. The member is not to transfer ahead of his family without approval from this office.
>
> These requirements indicate a direct involvement by the Department in the appellant's housing arrangements, carried to the extent of a flat prohibition against his transfer until suitable vacant accommodation was available; nor was he to transfer ahead of his wife and family. In effect, before he could take up his new appointment, he was required virtually then and there to occupy an available police house or failing that, find one himself. The employer's concern about housing is reflected in its obligation under Departmental regulations to reimburse him up to the prescribed limit, the evident intention being that all his relocation costs would be met. Its reasons for that concern can be readily understood. It must be very much to the advantage of the police force to have its members on transfer in suitable accommodation with their families as quickly as possible.
>
> *For these reasons the appellant was in a situation which was essentially different from that facing the generality of employees undertaking a transfer in the course of their work. They can normally make their own choice about the timing of their family move (if they decide the family should shift) and the type of accommodation*. Here, these matters are prescribed and are so closely tied to the new appointment that I am satisfied the appellant's expenditure in complying must be regarded as other than of a private or domestic nature, even though it is also associated with the continued existence of his domestic establishment.[Emphasis added]

204. It is clear from the above that the Court of Appeal considered *Hunter* was a special case and relied heavily on the special conditions promulgated in the Police Department's regulations relating to the transfer of police officers in deciding that the expenditure was deductible. The Court noted that ordinarily the sale and purchase of a family home is of a private and domestic nature.

205. In *Shell New Zealand Ltd v CIR*, the Court of Appeal concluded that lump sum payments made to employees to compensate them for capital loss on the sale of their properties and for mortgage interest assistance was taxable. In that case McKay J commented that "*the simple reimbursement of removal expenses incurred by the employee ……on transfer*" may require "*different considerations*" (implying that in some circumstances such costs would have been deductible to an employee). The Commissioner considers that this comment was *obiter*, and that drawing such an implication would be contrary to the general weight of authorities which suggests in these situations that relocation costs incurred by employees are of a private and domestic nature.

206. On the basis of the above, it is considered that as the first of the three questions has not been answered in the affirmative in respect of Example K, it is not necessary to consider the other two questions. The expenditure incurred by employee K would not qualify for exemption under section CW 13.

Overall conclusion on relocation expenditure

207. The Commissioner considers that employer reimbursements of relocation costs will qualify for exemption under section CW 13 (subject to the capital limitation not applying) only when the relocation costs relate to **a requirement in the employment contract** that the employee transfers **at the request** of the employer **at any time** and the employee is relocated **in the same job** and moves home to the new location.

Capital expenditure

208. Another exclusion from the general deductibility provision is the capital limitation provided for by section DA 2(1). This section denies a deduction for an amount of expenditure or loss to the extent it is of a capital nature. Therefore, if a payment or allowance reimburses an employee for capital expenditure it cannot be exempt under section CW 13.

209. Of the three examples of reimbursements and allowances (meal, clothing and relocation) discussed in this Interpretation Guideline, employee relocation reimbursements or allowances are most likely to involve expenditure of a capital nature.

Home relocation costs may be capital expenditure

210. Even when the necessary nexus exists between the expenditure incurred and the home relocation cost (such as in example J), when the transfer is with an existing employer there is still the question of whether the expenditure is of a

revenue or capital nature. It is now appropriate to consider whether some costs associated with the transferring of employees, especially the costs of selling an existing home and buying a new home, are of a capital nature.

211. The courts have applied several tests to assist in determining whether an expense is of a capital nature. The two that appear to be the most applicable for this discussion are:

- the identifiable asset test; and
- the enduring benefit test.

212. The above capital/revenue tests deal with the deductibility of business expenses by taxpayers involved in a business or trade. In the situation of reimbursements of relocation costs to employees, the employees are not business people or traders, so the cases dealing with the revenue/capital distinction do not fit neatly with the expenditure concerned. However, the cases do not exclude the type of expenditure under consideration.

The capital/revenue tests are now considered in relation to transfer expenses of employees.

Identifiable asset test: transfer expenses

213. Expenditure will meet the identifiable asset test (and be on capital account) when the asset or an advantage has been acquired by the expenditure incurred. The identifiable asset test was clearly enunciated in *Tucker (Inspector of Taxes) v Granada Motorway Services Ltd* [1979] 2 All ER where Lord Wilberforce said (at page 804):

> I think that the key to the present case is to be found in those cases which have sought to identify an asset. In them it seems reasonably logical to start with the assumption that money spent on the acquisition of the asset should be regarded as capital expenditure.

214. This case was cited with approval by the Court of Appeal in *CIR v McKenzies New Zealand Limited* (1988) 10 NZTC 5,233).

Enduring benefit test: transfer expenses

215. With the enduring benefit test the focus is on whether the particular payment is not entirely "once and for all" but is made for an asset or advantage that gives rise to an enduring benefit to the business in the sense that a benefit endures in the way that a fixed asset endures (*British Insulated and Helsby Cables Ltd v Atherton* [1925] All ER Rep 623). As their Lordships stated, expenditure is generally capital in nature if it is made:

> …not only once and for all, but with a view to bringing into existence an asset or advantage for the enduring benefit of trade.

216. This case was cited with approval by the Court of Appeal in *Poverty Bay Electric Power Board v CIR* (1999) 19 NZTC 15,001.

Employee transfer reimbursements – dwelling related expenses

217. Employee transfer reimbursements may include real estate commissions and solicitors' fees. In such situations it is arguable that the home acquired on transfer is an "identifiable asset". It is also arguable that the employee receives an enduring benefit from the purchase of the home in the sense that the employee has received a long-term benefit that enhances his or her career opportunities. These two aspects suggest that any expenditure associated with the sale and purchase of a house (real estate agents' commissions and solicitors' fees) must assume the same capital character as the underlying assets. Therefore the costs reimbursed to an employee for relocation are arguably of a **capital** nature.

218. In considering the exemption from tax in the hands of the employee (not the employer, who would generally be entitled to a deduction of the amounts reimbursed), the types of expenditure under consideration here (real estate agents' commissions and solicitors' fees) are of a capital nature. As such, this type of expenditure would not be deductible to the employee (if it were not for the employment limitation) because of the capital limitation under section DA 2(1). The expenditure, therefore, would not qualify for exemption in terms of section CW 13.

219. Other types of expenditure associated with transferring (such as transport costs and temporary accommodation), however, may qualify for exemption, provided there is the necessary nexus to the derivation of income. This is determined by applying the three requirements discussed above.

Conclusion Capital Expenditure

220. The Commissioner considers that the conclusions reached above are supported by the case law cited, although some of the cases were considered under now repealed legislation. When a sufficient nexus exists between the relocation expenditure and the derivation of income (such as in example J) some of the costs that could be exempt from tax as having the necessary nexus to the derivation of income may be excluded from that exemption because they are of a capital nature.

Exemption in respect of "expenditure on account of an employee": section CW 13(1)

221. As mentioned earlier, section CE 1 (Amounts derived in connection with employment or service) includes the term "expenditure on account of an employee". Section CW 13 provides exemption from income tax of certain payments that come within this term.

Section CW 13(2), as discussed above, deals with the exemption of "amounts" paid to employees (i.e reimbursements). This covers payments to the employee made in money.

222. A further exemption is provided by subsection (1), which covers situations where, rather than the employee being recompensed in money, the employer pays, on the employee's behalf, expenditure that is legally the employee's liability.

223. "Expenditure on account of an employee" is defined in section CE 5 as "a payment made by an employer relating to expenditure incurred by an employee". Any payment coming within this definition (subject to the exclusions in section CE 5(3)) will be assessable income to the employee.

However, section CE 5(3)(a) and (c) lists various exclusions from the definition. These are:

> (a) expenditure for the benefit of an employee, or a payment made to reimburse an employee under section CW 13
>
> (b) ….
>
> (c) expenses that an employee pays in connection with their employment or service to the extent to which the expenditure is their employer's liability, if the employee undertakes to discharge the liability in consideration of the making of the payment by the employer:

224. The definition, therefore, has two specific exclusions that are relevant to this discussion. Firstly, paragraph (a) of the definition excludes payments that would be exempt from tax in terms of section CW 13(2). Section CW 13(2), as already discussed, concerns the exemption of amounts paid (in money) that reimburse the employee for employment-related expenditure.

225. The second exclusion from the definition of "expenditure on account of an employee" is paragraph (c). This exclusion has been discussed earlier but, to reiterate, the exemption will apply when the expenditure meets the following requirements:

- The expenditure has been paid by the employee.
- The expenditure was paid by the employee *"in connection with the employee's employment or service"* (there has to be a nexus to the derivation of the employee's income).
- "To the extent" to which the expenditure is the *employer's liability and not the employee's* (the liability must be that of the employer).
- The undertaking by the employee to pay the *employer's liability* was the reason for the reimbursement being made to the employee.

Application of the exclusion in the definition of "expenditure on account of an employee".

226. The four requirements listed above are applied, as an illustration, to the reimbursement of solicitors' fees and real estate agents' commissions paid to relocating employees in the following scenario:

- An employee incurs the cost of selling their home in the old location and buying in the new location and both fees and commission are taken into account in the final settlement statement which is paid for by the employee. The fees and commission are the employee's liability.

- The employee makes a employee expense claim for the fees and commissions and is reimbursed by the employer.

227. In this situation the liability is that of the employee, so the second exclusion in the definition of "expenditure on account of an employee" will not apply. The reimbursement is an amount derived in connection with employment (expenditure on account of an employee) and the employee will have to rely on section CW 13(2) to exclude the payment from assessable income. This, as already discussed, requires the taxpayer to meet the deductibility requirements of section DA 2 (especially the private and capital limitations).

228. Another important point is that when a payment meets the exclusion by way of section CE 5(3)(c) ("expenditure on account of an employee") there is no need to determine whether that payment is of a revenue or capital nature. The exclusion does not make a distinction between revenue and capital payments.

229. The appendix to this Interpretation Guideline contains three flow charts to assist in determining how any reimbursement or other payment (other than salary and wages) made by an employer to an employee is to be treated for income tax purposes.

Additional transport costs: section CW 14

230. Another income tax exemption in respect of income from employment is contained in section CW 14. This exemption is in respect of allowances or payments made to employees in respect of "additional transport costs". This is a defined term and the exemption applies to specific factors listed in section CW 14(3).

231. Subsection (3) is not linked, as is section CW 13 (discussed above), to the requirement that to qualify for deductibility, and therefore an income tax exemption, it must meet the general deductibility tests of section DA 1, if it were not for the employment limitation. Therefore, there is not the same denial of exemption for allowances that cover private or domestic or capital expenditure, apart from the fact that such expenditure, travelling between home and work, is generally regarded as being of a private nature. However, to qualify for exemption these transport allowances must meet the strict requirements set out in the factors listed in section CW 14(3).

Estimated expenditure of employees: section CW 13(3)

232. As noted earlier section CW 13(3) provides that the employer may make a "reasonable estimate" of the amount of expenditure likely to be incurred by an employee or a group of employees for which a reimbursement is made. When groups of employees are concerned, the Commissioner will accept a reasonable estimate for each group or part of a group depending on the particulars of each case.

233. To arrive at a reasonable estimate the Commissioner would expect the employer to survey the employees in a group to determine the average amount each employee incurs.

Such an estimation is treated as though it is the amount incurred during the period to which the estimation relates.

General comment

234. This Interpretation Guideline concludes that some allowances or payments made to employees that may have been treated as exempt from income tax in the past will no longer qualify for exemption under the current legislation.

235. The principal reason for this change of position relates to the 1995 legislative amendment to section CB 12 of the Income Tax Act 1994 (1994 Act) (the forerunner to section CW 13 of the current Act). One of the intentions of the 1995 amendment was to explicitly exclude from exemption payments or allowances made to employees to reimburse them for expenditure of a capital nature. This was done by importing, into section CB 12 the general deductibility tests of section BD 2(2) (1994 Act).

236. While the amended section CB 12 achieved that aim, in relation to allowances of a capital nature, the same amendment also affected the treatment of some allowances or payments made to employees which could be seen to be of a private or domestic nature.

This Interpretation Guideline sets out the Commissioner's considered view on the interpretation of the currently worded section CW 13.

Flow Charts to assist in applying the section CW 13 requirements

237. The flow charts in the appendix provide guidance in determining where an amount is an "amount derived in connection with employment or service", whether it is exempt from tax in the hands of the employee, or is subject to fringe benefit tax, by illustrating the steps that are required when applying the legislation. The flow charts include the private and domestic versus necessary nexus tests (through the application of the "three questions") and whether the expenditure under consideration is of a capital nature.

238. In determining whether any allowance or reimbursement will qualify for exemption under the present legislative regime it will be necessary to look at the specific terms of the employment contract entered into (whether written or implied). Each case will need to be considered on its own facts. This

Interpretation Guideline, including the flow charts, is designed to assist in the decision-making process.

Conclusions

239. The conclusions reached in this Interpretation Guideline can be summarised as follows:

- Generally allowances paid to employees and amounts paid as expenditure on account of an employee are income of the employee under section CE 1. However, these amounts can qualify for exemption under section CW 13 or be excluded from income under section CE 5(3)(c).

- For an amount paid to be exempt income under section CW 13, the expenditure for which the payment is made must be such that it would be an allowable deduction to the employee, if the employment limitation did not exist.

Application of the three questions in determining exemption under section CW 13

240. In order for the exemption in section CW 13 to apply to exempt an allowance or reimbursing payment (not being an allowance or a payment made to the employee in respect of capital expenditure employed by the employee), the following three questions must be answered in the affirmative:

(i) Was the employee performing an obligation under the contract of service at the time the expenditure was incurred?

(ii) Did the obligation serve the purpose of the income-earning process of deriving income from employment?

(iii) Was the expenditure incurred by the employee necessary as a practical requirement of the performance of the obligation?

241. Care needs to be taken in applying these questions to fact situations. It is important that the obligation under the employment contract (question 1) is correctly identified. For example, in *Belcher* the obligation was not to live overseas or to spend money on accommodation, but to do the research. In performing this "obligation", from which the taxpayer derived gross income, the need for the accommodation flowed.

242. The first question must be answered in the affirmative before the second question is asked, and the second question must be answered in the affirmative before the third question is asked. If the first and second questions are met, then, under the third question, the expenditure must result as being necessary as a practical requirement of meeting the employment obligation. Generally, this requirement relies on case law, as demonstrated in the application of all three questions to the examples above.

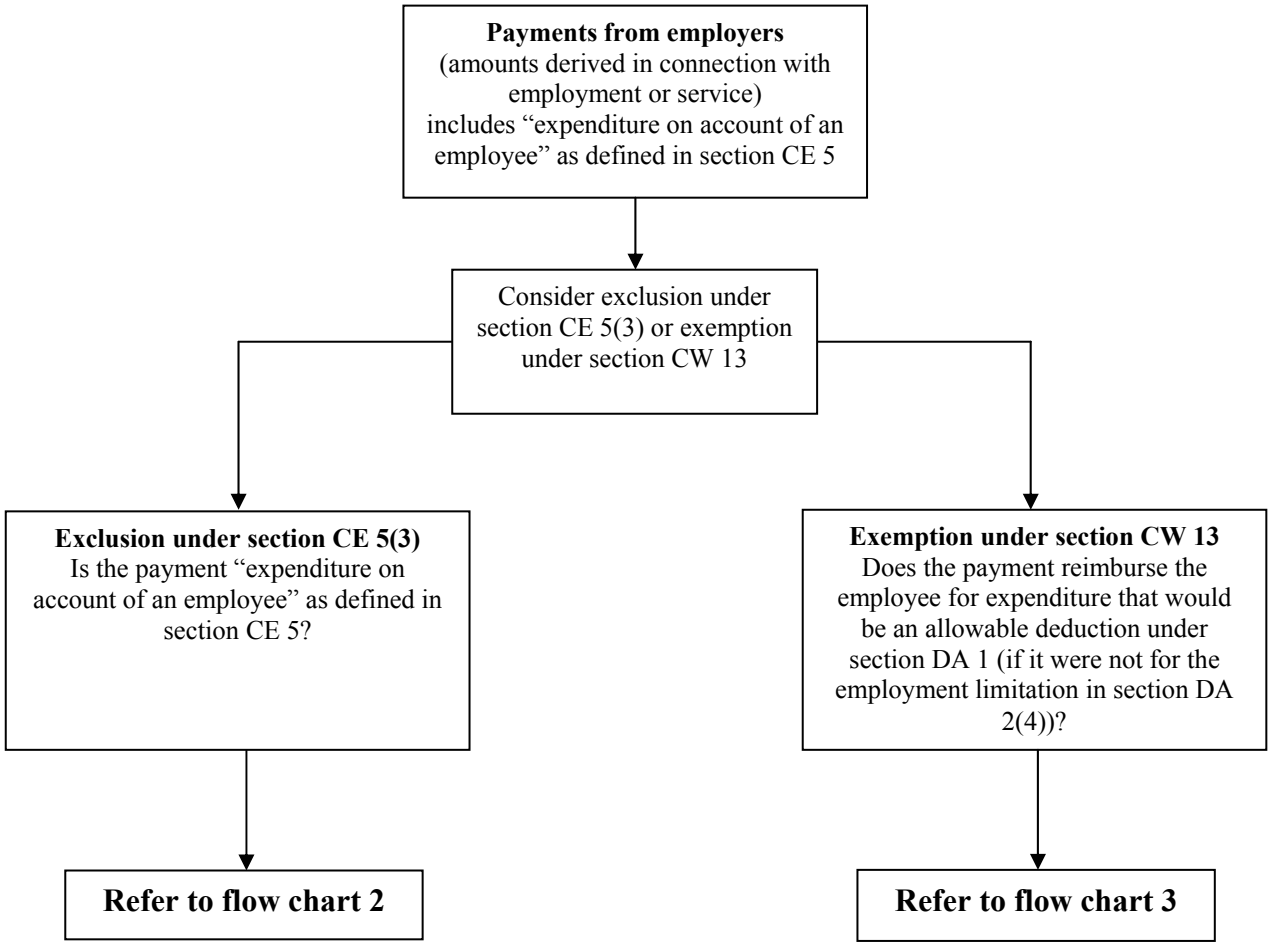
243. However, any allowance or reimbursement paid to cover an employee's **capital** expenditure will not qualify for an exemption under CW 13. For example, a weekly allowance paid to an employee to cover (over a period) the purchase price of a computer that was installed in the employee's home, at the employer's request, so the employee could deal with work-related overnight email and so on, would not qualify for exemption.

Exemption of "expenditure on account of an employee" under section CE 5(3)

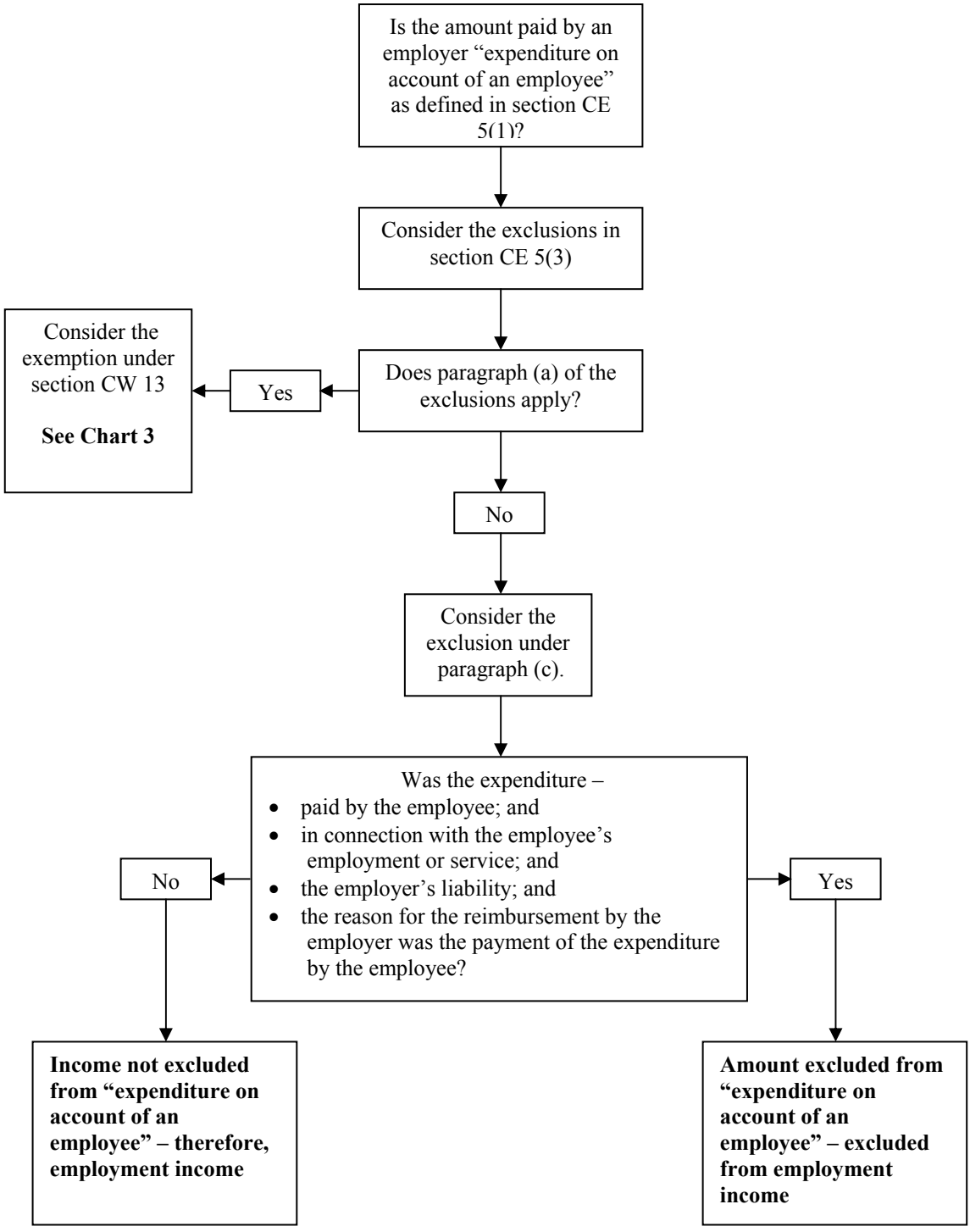
244. Where an employee is reimbursed by their employer for expenditure paid in connection with their employment where that expenditure is the liability of their employer, the amount reimbursed is excluded from income. However, the employer may still need to consider whether there has been a benefit provided to the employee (to which the liability related) which is subject to fringe benefit tax.

APPENDIX

Flow chart 1: Whether amounts paid by employers are exempt income or excluded income of employees?



Flow chart 2: Operation of section CE 5 – Expenditure on account of employee[2]



The results of applying the "tests" in these charts may conclude that a payment (or expenditure on account of an employee) is exempt or excluded from income tax to the employee, the employer should also consider if a liability for fringe benefit tax exists

[2] This chart does not consider the exclusion under section CE 5(3)(b) for an allowance for additional transport costs under section CW14.

Flow chart 3: Operation of section CW 13